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TAX REFORM PROPOSALS: TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet[1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee reviews of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets. It describes and analyzes tax provisions and proposals relating to the taxation of foreign income and foreign taxpayers.

The pamphlet describes present law tax provisions and the various tax reform proposals made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department Report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals. Each of Parts II–VII of the pamphlet includes an analysis of the tax-related issues.

The first part of the pamphlet is an overview. The second part discusses the tax treatment of operations and investments of U.S. taxpayers conducted through foreign corporations. Part three discusses the foreign tax credit rules. Special tax rules for Americans working abroad, income earned in U.S. possessions, and Americans exporting through Foreign Sales Corporations (FSCs) are covered in part four. Part five discusses the taxation of foreign currency exchange rate gains and losses. The sixth part addresses certain tax rules applicable to foreign taxpayers earning U.S. income. Finally, part seven discusses U.S. income tax treaties.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS–25–85), July 18, 1985.

I. OVERVIEW

Scope

This pamphlet discusses U.S. income tax rules governing foreign income and foreign taxpayers. Other matters that are relevant to a full consideration of international trade, such as U.S. tax rules that apply in purely domestic transactions and consumption taxes, are discussed in other tax reform pamphlets to be issued by the staff of the Joint Committee on Taxation.[2] The pamphlet includes a description of present law as well as alternative proposals including the President's tax reform proposal, the 1984 Treasury Report, and pending Congressional bills.

Summary

Foreign corporations

The use of a foreign corporation sometimes provides U.S. taxpayers a U.S. tax benefit. U.S. taxpayers generally do not pay U.S. tax currently when foreign corporations that they own earn income. Instead, they generally defer tax until the foreign corporations send those earnings home to the United States. Pending Congressional bills would reduce or eliminate this deferral privilege. In addition, a U.S. taxpayer that disposes of the stock of a foreign corporation may pay tax on the gain from that disposition at the preferential capital gains rate. Pending legislation would eliminate or restrict that preference.

Foreign tax credit

The foreign tax credit allows U.S. taxpayers, within limits, to reduce their U.S. taxes dollar for dollar by the amount of the foreign taxes they pay. The foreign tax credit limitation prevents taxpayers from using foreign taxes to reduce U.S. tax on U.S. income. Currently, an "overall" foreign tax credit limitation applies: taxpayers may credit taxes from one country against U.S. tax on income from anywhere outside the United States. The Administration proposal would substitute for this overall limitation a "per country" limitation, so that one country's taxes generally could not offset U.S. tax on income from another country. The proposal would look through tiers of foreign corporations to accomplish this goal. The Administration proposal also would make a number of other significant changes to the foreign tax credit limitation.

Whether there is an overall or a per country limitation, all income must have a "source," that is, generally, it must arise in the United States, another country, or elsewhere outside the

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[2] Capital cost recovery, the taxation of capital gains, and consumption taxes (such as the value-added tax) are discussed in a forthcoming pamphlet on the taxation of capital income.

United States. The Administration proposal would modify the current source rules. In particular, it would tend to assign more income from sales of property to the residence of the seller than does current law. The Administration proposal would also change certain of the rules that assign expenses to gross income for the purpose of calculating net income from a country. The Administration would require taxpayers to allocate interest expenses on the basis of an entire U.S. consolidated group (not just the member of the group that borrowed the money). The proposal also would make other significant changes to the source rules.

Another important issue in international tax law is whether the United States should treat a particular foreign tax as an income tax in the U.S. sense that is eligible for the foreign tax credit. Other issues involving the foreign tax credit are the way in which the United States should credit taxes paid by foreign corporations with significant U.S. corporate ownership (the "deemed-paid credit"), and the treatment of foreign and U.S. losses for the purpose of the foreign tax credit limitation. The Administration proposal would create new rules for the treatment of deemed-paid credits and foreign and U.S. losses.

U.S. persons with foreign income

Present law contains a number of tax rules that favor certain taxpayers with foreign income. U.S. taxpayers may owe no U.S. tax on their first $80,000 of foreign earned income, and U.S. government employees benefit from some special tax rules. Export income is eligible for reduced rates in some cases under the Foreign Sales Corporation legislation of 1984. Pending bills would reduce or eliminate these preferences.

Special tax rules apply to operations in Puerto Rico and the other U.S. possessions. Some of those rules provide incentives, while others attempt to coordinate U.S. and possession tax rules. The Administration proposal would replace the existing incentives with a wage credit, and would modify the rules coordinating U.S. and possession rules. Pending bills would reduce or eliminate the current incentives for operations in the possessions.

Foreign currency exchange rate gains and losses

Under present law, the treatment of transactions involving foreign currency gains and losses is in some instances inconsistent or unclear. Present law provides taxpayers with significant tax planning opportunities in the translation of currency gains and losses from foreign business operations. The Administration proposal would treat foreign currency gains as interest income, and foreign currency losses as interest expense. It would require current accrual of these amounts to the extent "anticipated." Also, the Administration proposal generally would impose a single set of rules governing foreign operations in branch and subsidiary form.

Foreign taxpayers

When foreign taxpayers earn gross income from a U.S. business, they must allocate interest expenses, among others, to arrive at taxable income. U.S. corporations that belong to foreigners may avoid U.S. tax in some cases by paying deductible interest to relat-

ed foreign parties that may not be taxable in the United States. While dividends from U.S. corporations are subject to U.S. tax at the shareholder level, earnings of U.S. branches of foreign corporations may never bear a U.S. tax at the shareholder level. The Administration seeks to impose a branch-level tax to serve as a surrogate for that shareholder level tax.

Income tax treaties

For U.S. income of U.S. taxpayers, the Internal Revenue Code is generally the highest authority. In the international area, however, a series of bilateral income tax treaties alters the Code's rules. In recent years, Congress has not adopted implementing legislation for treaties affecting the revenue on a treaty-by-treaty basis, as it did in prior years. The Administration proposals consistently defer to existing treaty obligations.

II. USE OF FOREIGN CORPORATIONS

Present law treats U.S. shareholders of foreign corporations differently depending on (a) the degree of U.S. shareholder contol over the foreign corporation, (b) the concentration of that U.S. control (i.e., whether it is widely or closely held) and (c) the activities of the foreign corporation.

If a foreign corporation is not controlled by U.S. persons, a U.S. shareholder is not generally subject to U.S. tax on the corporate earnings until he receives a dividend distribution, or disposes of his stock. On disposition, the stock is eligible for capital gains treatment, assuming it is a qualifying capital asset.

On the other hand, if a foreign corporation is classified as a "controlled foreign corporation," certain undistributed income is taxed currently to certain substantial (generally, 10 percent or more) U.S. shareholders. Furthermore, to the extent undistributed income is not of the type that is taxed currently, the shareholder can be taxed at ordinary U.S. rates (rather than capital gains rates) when the stock is sold.

Other foreign corporations controlled by a small number of U.S. persons and engaged in basically passive investment activities are classified as "foreign personal holding companies," whose undistributed income is taxed currently to U.S. shareholders.

In addition, some foreign corporations are controlled by a large number of U.S. shareholders but do not have the concentration of U.S. control necessary for undistributed earnings to be taxed to U.S. shareholders. If such a corporation is a "foreign investment company" engaged in certain investment activities, a portion of a shareholder gain on disposition of stock can be taxed as ordinary income.

The discussion below generally addresses corporations that are controlled by U.S. persons. The discussion begins in Parts A and B with an examination of 10-percent or more U.S. shareholders of controlled foreign corporations. Part C considers smaller investors in foreign investment companies.

A. Deferral of Tax on Earnings of Foreign Corporations

Present Law and Background

Two different sets of U.S. tax rules apply to American taxpayers that control business operations in foreign countries. The use or non-use of a foreign corporation determines which rules apply. (To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.)

Direct operations—current tax

One set of rules applies to U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation). The income from those operations appears on the U.S. tax return for the year the taxpayer earns it. The United States generally collects tax on that income currently. The foreign tax credit, discussed below, may reduce or eliminate the U.S. tax on that income, however.

Indirect operations—generally tax deferral

The other set of rules applies to U.S. persons that conduct foreign operations through a foreign corporation. In general, a U.S. shareholder of a foreign corporation pays no U.S. tax on the income from those operations until the foreign corporation sends its income home to America (repatriates it). The income appears on the U.S. owner's tax return for the year it comes home, and the United States generally collects the tax on it then. The foreign tax credit may reduce or eliminate the U.S. tax, however. (The foreign corporation itself will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.)

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, an actual dividend payment ends deferral: any U.S. recipient must include the dividend in income. Second, in the case of a controlled foreign corporation, an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a sale of shares of a foreign corporation triggers tax, sometimes at ordinary income rates (sec. 1248 or sec. 1246), as discussed in B and C below.

Indirect operations—current tax for some income

Deferral is not available for certain kinds of income (referred to here as "tax haven income") under the Internal Revenue Code's subpart F provisions. That is, when a U.S.-controlled foreign corporation earns tax haven income, the United States will generally tax the corporation's 10-percent U.S. shareholders currently. In effect, the Internal Revenue Code (the "Code") treats the U.S. shareholders as having received a current dividend out of the tax haven income. In this case, too, the foreign tax credit may reduce or eliminate the U.S. tax.

This tax haven income, which is currently taxable under subpart F of the Code, consists of several kinds of income that are generally suited to tax haven operations. In general, tax have income consists of financial income and income that is easy to shift to a location of the taxpayer's choosing. Tax haven income is not limited to those kinds of income, however. The definition of tax haven income is complex. Tax haven income includes foreign personal holding company income (generally passive income such as interest, dividends, gains from sales of stock and securities, and some rents and royalties). Some dividends and interest received from a related cor-

poration operating in the same country as the controlled foreign corporation recipient are not tax haven income, however. Royalties and rent received from a related corporation for use of property in the income recipient's country are not tax haven income, but other rents and royalties received from a related corporation are tax haven income. Royalties and rents from a related partnership or other noncorporate entity are not tax haven income, so long as the recipient earns them in "the active conduct of a trade or business".

Tax haven income also includes income from related party sales routed through the recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. It also includes shipping income, unless the controlled foreign corporation reinvests its earnings in shipping operations. It generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income. It includes income from the insurance of U.S. risks, income from insurance of related party risks wherever located, and income from factoring related party receivables.

The rules ending deferral for tax haven income provide thresholds below which they do not operate. The controlled foreign corporation rules (of subpart F) generally apply only if 10 percent or more of the foreign corporation's gross income is tax haven income. These controlled foreign corporation rules, which apply even to foreign subsidiaries of widely held U.S. corporations, apply only if more than 50 percent of the voting power of the foreign corporation belongs to U.S. persons who own at least 10 percent each of the voting power. Older, similar, but less extensive rules, the foreign personal holding company rules (secs. 551-58), which apply to foreign corporations closely held by individuals, apply only if more than 50 percent of the value of the corporation belongs to five or fewer U.S. individuals. (Those foreign personal holding company rules are designed to deal only with passive investment income.) By contrast, under the deemed paid foreign tax credit rules discussed in Part III.E., below, when a U.S. corporation receives a dividend from a foreign corporation, a lower threshold generally allows the U.S. corporation to credit foreign taxes paid by the foreign corporation, if the U.S. corporation owns 10 percent of the foreign corporation's voting stock, even if the other 90 percent belongs to foreign persons.

Legislative history

In 1962, the Kennedy Administration proposed the general repeal of deferral with respect to controlled foreign corporations. The House voted to repeal deferral, with an exception for reinvested income. The Senate voted to impose current tax on only certain types of income of controlled foreign corporations, and Congress basically followed the Senate approach. Those 1962 rules form the basis of current law. In 1973, the Nixon Administration proposed repeal of deferral for two additional kinds of income: (1) income from "runaway plants," that is, income that a controlled foreign corporation earns from manufacturing goods that it imports into the United States, and (2) income that benefits from tax holidays, that is, temporary tax reductions at the beginning of foreign busi-

ness operations. Congress did not enact that proposal. In 1975, Congress made unreinvested foreign shipping income a kind of tax haven income and eliminated an exception for certain reinvested income from less developed countries. In 1976, Congress liberalized the investment in U.S. property rules to allow controlled foreign corporations to invest in stock and debt of unrelated U.S. companies and in certain oil exploration equipment. In 1977, a Task Force of the House Committee on Ways and Means studied the question of deferral, but recommended no change in the law that existed then. In 1978, the Carter Administration proposed general repeal of deferral, but Congress did not act on that proposal. In 1982, Congress ended deferral for downstream oil income. In 1984, Congress repealed deferral for income from factoring related party receivables and clarified the rules that apply to related party insurance.

Proposals

1. S. 409 and H.R. 800 (Bradley-Gephardt) would repeal deferral for U.S.-controlled foreign corporations; that is, they would impose current tax on all foreign operations of a U.S. taxpayer conducted through a controlled foreign corporation.
2. H.R. 1377 (Stark) would impose current tax on 20 percent of the income that benefits from deferral; S. 556 (Chafee) would impose current tax on 15 percent of the income that benefits from deferral.

Possible Proposals

1. Congress could repeal deferral only for selected categories of income of controlled foreign corporations. Possible categories include:
   a. Income from "runaway plants," that is, income that a controlled foreign corporation earns from manufacturing goods that it imports into the United States. H.R. 1914 (Traficant) would end deferral for this category of income.
   b. Income that benefits from tax holidays, that is, temporary tax reductions at the beginning of foreign business operations. H.R. 1914 (Traficant) would end deferral for this category of income.
   c. Income from low-tax countries, e.g., countries whose income tax rates are lower than a specified percentage of net income.
   d. Interest or royalty payments that reduce a related payor's tax haven income, whether or not they come from a related person operating in the same country.
   e. Income from rents and royalties received from related persons that are not corporations, unless they pay for rights in the recipient's country.
2. Congress could change the definition of controlled foreign corporation to impose current tax on tax haven income when half or more of a foreign corporation, by vote or value (not merely vote), belongs to 10-percent U.S. shareholders.

3. Congress could eliminate deferral on tax haven income for any 10-percent U.S. shareholder, whether or not the corporation is U.S. controlled.

4. Congress could replace the current de minimis rule (allowing deferral unless 10 percent of gross income is tax haven income) with a de minimis rule based on a percentage of earnings and profits, e.g., ending deferral if 10 percent of earnings and profits are tax haven income. Alternatively, Congress could provide a dollar de minimis amount, e.g., $1 million.

Analysis

Retention, limitation, or elimination of deferral

Impact of direct investment overseas on the U.S. economy and jobs

Both sides on the deferral issue provide economic analysis to support their conclusions that deferral helps or hurts the U.S. economy and U.S. jobs. Both sides generally agree that deferral tends to permit or stimulate direct investment by U.S. businesses in plant and equipment abroad, but there is considerable dispute about how that direct investment affects the U.S. economy.

Those who favor deferral base their economic analysis on the assumption that the amount of investment abroad by U.S. companies is determined by profitable investment opportunities abroad and is thus generally independent of the level of investment in the United States. Their analysis concludes that the increased direct investment abroad resulting from deferral leads to increased sales and more rapid growth of U.S. multinational firms, which increases their ability to undertake research and reduces their per unit administrative and other fixed costs, all of which leads to an increase in profits and a consequent increase in investment both in the United States and abroad. They say that any reduced U.S. investment overseas would not necessarily increase U.S. investment in America. For example, the capital not invested overseas might be consumed, or it might be capital of foreign lenders that would not lend to U.S. corporations (because the anticipated rate of return on U.S. investment is too low).

Those who oppose deferral, by contrast, assume that direct investment abroad by U.S. multinational companies is often a substitute for investments they would otherwise make in the United States. They argue that if Congress eliminates the encouragement to direct investment overseas that deferral provides, capital investment in the United States would increase—stimulating U.S. employment and increasing Federal revenues substantially beyond any amounts that would be collected from foreign income.

The amount of foreign investment financed by U.S. funds flowing from U.S. parents to foreign subsidiaries is substantially less than the cash inflow which the U.S. parents have received in recent years from past investments in foreign subsidiaries. (See, e.g., U.S. Department of Commerce, *Survey of Current Business,* December 1984, p. 54.) Foreign investment has thus been "profitable" to the U. S. investor. This does not necessarily mean that the investment is beneficial to the U.S. economy, however. Those opposed to defer-

ral argue that foreign investment decreases the capital available for domestic investment. First, they argue, taxpayers could have made the original investment in the United States. Second, if the capital had been invested in the United States, the retained earnings as well as the distributed earnings would have been more likely to be reinvested in the United States.

Those favoring deferral argue that overseas investment, rather than resulting in a decrease of jobs in the United States, in fact tends to create U.S. employment by enabling U.S. companies to penetrate foreign markets. Although part of what is sold in the foreign markets is manufactured overseas, a part also is manufactured in the United States for sale or for further processing abroad. The extent to which foreign subsidiaries use U.S.-manufactured products for their overseas markets varies widely within industries and within companies, and it is more likely that a newly established foreign subsidiary would need to rely upon products manufactured in the United States to supply foreign customers than a more mature business. Those who oppose deferral generally concede that in many situations U.S. manufactured goods are exported through foreign subsidiaries, but they counter that in many other situations foreign subsidiaries benefiting from deferral compete in the overseas (and, in some cases, domestic) markets with U.S. based companies subject to current U.S. tax.

Thus the key to whether any encouragement to direct foreign investment helps or hurts the U.S. economy and U.S. jobs remains whether increased foreign investment leads to decreased domestic investment. Economists disagree about the answer to this question.

The significance of deferral as an incentive to foreign investment

Although, as indicated above, they strongly disagree on its implications, both sides to the deferral argument appear to agree that deferral results in more foreign investment than would occur if the United States taxed earnings of U.S.-controlled foreign corporations currently. Clearly, the longer the tax deferral period and the more the U.S. tax burden exceeds the foreign tax burden, the greater the tendency to invest abroad. In addition, the present tax treatment of controlled foreign corporations in some cases provides some inducement to reinvest abroad earnings from foreign sources. For example, given equal investment opportunities in the United States and in a foreign country, a U.S. shareholder of a controlled foreign corporation might conclude that the funds should stay invested overseas rather than come back to the United States since any increased investment in the United States would have to be net of U.S. taxes on the amount repatriated. Thus, there would be less funds to invest in the United States than overseas, and the return on the investment would be smaller. In 1980, IRS reports indicate that the effective rate of foreign tax on earnings of U.S.-controlled foreign corporations (the ratio of foreign tax to earnings and profits) averaged approximately 30 percent.[3] Given a 46-per-

[3] Internal Revenue Service, *Statistics of Income Bulletin*, Spring 1984, p. 52.

cent statutory U.S. corporate tax, repatriation of these amounts may have caused significant U.S. tax.

The current deferral system generally treats investments in U.S. property (such as increased loans from a foreign subsidiary to its U.S. parent) like dividends, and taxes them currently. The rules governing these loans and other investments in U.S. property have not always yielded appropriate results in practice. For example, taxpayers have used these rules deliberately to trigger income and to credit more foreign taxes than they could otherwise have credited. Absence of any rules governing investments in U.S. property, however, would in effect exempt the income of foreign subsidiaries of U.S. taxpayers from U.S. tax. The current treatment of dividends and investments in U.S. property highlights one aspect of the deferral system: it discourages U.S. taxpayers from bringing home earnings of foreign subsidiaries. This incentive not to repatriate arises because, in the current deferral system, the United States taxes earnings of U.S.-owned foreign corporations only on repatriation. Moving to either a harsher treatment, ending deferral, or a more lenient treatment, exempting foreign income from tax altogether, would remove the incentive to leave profits in foreign subsidiaries. In either case, repatriation would not trigger tax.

There are, of course, many reasons for making investments abroad in addition to tax reasons. Commercial laws, tariffs and import restrictions, proximity to natural resources, currency laws, or merely the attitude of government officials or the public generally may make it advisable to invest abroad rather than in the United States, if a corporation is to sell its products in a foreign market. Similarly, labor costs, transportation costs, or even location in a country that allows favorable access to the Common Market may lead to investment overseas rather than in the United States. Of course, tax concessions in one country may influence the choice of a location there after the enterprise has decided to produce outside the United States for nontax reasons.

Neutrality and competitiveness

Deferral presents this issue: How should the United States treat U.S.-owned foreign corporations that earn active income (non-tax haven income) in foreign countries? Should the United States tax their income as they earn it, as it taxes the income of U.S. corporations? Should the United States instead disregard their income until it comes home, arguably to put them on a par with their foreign competition?

If the foreign tax on profits of foreign investments of U.S.-controlled foreign corporations is lower than the U.S. tax on profits from U.S. investments, deferral does not provide for tax neutrality between those investments. Opponents of deferral contend that, in those cases, it gives U.S. taxpayers an incentive to invest overseas. They maintain that the tax incentive to invest abroad provided by deferral in these cases conflicts with the general policy of the United States, reflected in the adoption of the foreign tax credit, to promote tax neutrality as between U.S. and foreign investment.

Advocates of deferral respond that if the United States ends deferral and taxes the income of U.S.-controlled foreign corporations

currently, the United States will be the only major industrialized country that does so. Most foreign countries have a deferral system like the current U.S. system. Some foreign countries impose little or no tax on the earnings of foreign subsidiaries even when the earnings come home. Proponents of deferral note that U.S.-controlled foreign corporations would sometimes bear higher tax than their locally owned (or third-country owned) competition. This higher tax, they argue, would place U.S. businesses operating overseas at a competitive disadvantage to foreign multinational businesses operating in the same countries. They contend that the correct view of neutrality looks at the place where businesses use capital, and would allow U.S. businesses to operate in a foreign country on the same terms (including taxation) as all other businesses in that country. Opponents of deferral, on the other hand, cite the relatively low U.S. tax revenue estimates assigned to repeal and argue that repeal would produce only a marginal increase in the overall tax burden of U.S. multinationals and thus should not significantly affect their competitiveness.

Opponents of deferral also argue that the United States should not make taxation depend on an artificial factor: whether the U.S. taxpayer has chosen to conduct its operations through a foreign corporation rather than directly. Moreover, they do not think it appropriate to allow U.S. taxpayers to decide when income will be taxable. They argue that this flexibility allows taxpayers to arrange their income to minimize taxes rather than to reflect economic activity. Moreover, elective deferral allows taxpayers who anticipate losses to operate directly and bring those losses onto the U.S. tax return currently. Proponents of deferral counter that, whatever form elimination of deferral may take, it will not eliminate all differences between direct and indirect foreign operations. They also argue that a decision to conduct foreign operations through a foreign subsidiary rather than directly is often based largely on non-tax factors, such as local regulatory requirements.

Lower rates and broader base

The thrust of the Administration proposal, to reduce U.S. tax rates while broadening the base, bears on the deferral issue. First, repeal of deferral is less burdensome as U.S. rates decrease. The Administration proposal would reduce the corporate tax rate to 33 percent. In general, statutory and effective tax rates in the world's major industrialized countries exceed 33 percent. U.S. companies that bear foreign tax rates greater than 33 percent would pay no additional U.S. tax if Congress both imposed a 33-percent corporate rate and repealed deferral. (Foreign income now benefits from fewer tax preferences than U.S. income, so the base broadening proposals have less impact on foreign income.) Second, an increase in the total amount of tax that the United States collects on business income that taxpayers earn in the United States arguably tends to militate for the repeal of deferral. The Administration projects an increase in the total tax burden on domestic business if Congress adopts the entire Administration proposal. This increase would occur because base broadening measures would increase corporate taxes more than rate reductions would decrease corporate taxes. Some taxpayers suggest that they may move operations off-

shore in the event that comprehensive reform imposes much more of a tax burden on U.S. operations than does current law. If Congress repeals deferral, taxpayers may reconsider any plans to leave the United States for tax reasons.

Simplification

Opponents of deferral argue that repeal would simplify the tax law. It would reduce the need for a number of complicated provisions in present law that seek to prevent shifting of income to foreign corporations. This is because repeal would reduce the incentive for U.S. taxpayers to avoid U.S. tax by undercharging foreign affiliates for various items. It could also eliminate the ability to manipulate the foreign tax credit that arises when taxpayers conduct some foreign operations directly, and other foreign operations through foreign subsidiaries. It could eliminate the tax avoidance opportunity that arises when U.S. taxpayers decide when certain income will become subject to U.S. tax. Moreover, under present law, currency exchange gains and losses, capital gains and losses, and other tax results depend on whether a taxpayer conducts foreign business directly or through a foreign corporation.

Advocates of deferral reply that the foreign tax credit mechanism will still require rules to prevent shifting of income to foreign corporations. They argue, in addition, that repeal would be difficult to administer. For example it would require more audits of controlled foreign corporations and new rules for loss acquisitions, blocked currency, and other matters.

Interaction with foreign tax credit limitation

The repeal of deferral could affect the allocation of deductions for purposes of computing the foreign tax credit limitation (discussed in more detail in Part III, below). The foreign tax credit limitation divides taxable income into two categories: U.S. income, which is fully taxable, and foreign income, which the foreign tax credit can shelter. In certain situations, current law provides that, in computing the foreign tax credit limitation of a U.S. parent company, its deductions, such as interest and home office expenses, which in part benefit the operations of its foreign subsidiaries, may be allocated between U.S. and foreign sources in proportion to the gross income of the parent from sources within and without the United States. Under present law, the gross income of the parent attributable to the operations of a foreign subsidiary is the dividend income received from the subsidiary. If Congress repealed deferral, however, it would be logical to consider the gross income of the subsidiary—ordinarily a much larger amount. Since the U.S. parent's gross income from foreign sources would thus be greater absent deferral, its deductions allocable to foreign sources would likewise be greater. While this change might tend to increase the parent's U.S. tax, there could also be a countervailing increase in the foreign tax credit limitation resulting from the allowance of the subsidiary's deductions for interest, etc., as offsets against the parent's deductions allocated to foreign sources. While the net effect of these two changes with respect to the allocation of deductions may be a substantial increase in tax liability for many companies, for many others the net effect would probably be a substan-

tial tax reduction. Arguably, these changes would constitute an important rationalization and simplification of the rules governing the allocation of deductions. These changes could be criticized, on the other hand, on the ground that they reduce foreign tax credits, increase tax, and hurt competitiveness.

Runaway plants, tax holidays, and low-tax countries

Those who argue that deferral constitutes an incentive which makes investments overseas more attractive than investments in the United States, thereby displacing investments and jobs in the United States, tend to focus on three situations in which their argument is most persuasive. The first situation is where a U.S. company conducts manufacturing operations overseas through a foreign subsidiary which exports some of its products back to the United States—referred to as a "runaway plant." The second situation is where a U.S. company establishes operations overseas in order to take advantage of substantial tax incentives provided by a foreign country to induce U.S. investment within its borders—referred to as a "tax holiday." The third situation is where a foreign country imposes a low tax rate on a permanent basis.

Some advocates of deferral argue that if the problems with deferral are essentially those presented by the runaway plant, tax holiday, and low tax country situations, then it might be appropriate to retain deferral as a general rule and eliminate it only for these three problem areas. Treasury proposed to repeal deferral for the first two of these in 1973. Under this approach, the earnings of the controlled foreign corporation could be subject to tax as deemed distributions under the existing statutory framework applied to subpart F income. Deferral could be eliminated with respect to income of a runaway plant where the income is derived from U.S. sources or from sales of goods intended for ultimate consumption or disposition in the United States. Deferral could be eliminated for income of subsidiaries benefiting from a foreign tax holiday where (1) the foreign subsidiary qualifies for an exemption from foreign tax for a period of years, (2) it qualifies for a substantial reduction in tax rates over those generally applicable in that country, or (3) it is allowed capital cost recovery allowances substantially greater than those allowed under U.S. law. Deferral could be eliminated for income of subsidiaries that operate in low tax countries. For this purpose, Congress could, for example, define low tax countries as those that impose income taxes at a rate that is less than 50 percent (or some other fraction) of the U.S. rate.

The impact of the tax holiday proposal and the low tax country proposal would appear to fall primarily upon those developing countries which are engaging in efforts to industrialize by offering tax incentives to foreign investors. In some situations, these developing countries could be adversely affected by these proposals without substantial advantage accruing to the United States; much of the advantage might accrue to developed countries. For example, U.S. investment in Ireland is generally made in lieu of investment on the European Continent. Any attempt to nullify the Irish industrial incentive might not result in additional investment in the United States but in a loss of investment in Ireland to the developed European countries. Another problem with tax holiday pro-

posals is that they would involve substantial complexity and administrative difficulties in determining when a tax holiday existed. Similarly, there could be great difficulty in drafting an adequate, administrable definition of low tax country. Any mechanical rate test might give countries an incentive to boost their tax rates to meet the U.S. test rate.

While some persons feel that the runaway plant proposal terminates deferral in those cases where American jobs are currently being lost, it can also be viewed as hurting U.S. industry to the advantage of foreign competitors. For example, if a U.S. manufacturer decides to do some of his manufacturing overseas in order to compete with foreign imports while retaining the balance of its manufacturing and processing in the United States, taxing the manufacturer's foreign operations would adversely affect the U.S. company but would leave the foreign competitors untouched even though the U.S. company is creating U.S. employment to the extent it retains some of its operations in the United States.

Same country interest and royalties

The rationale for the possible proposal to impose current tax on deductible payments by a related same country payor that reduce the payor's tax haven income is that it would prevent potential circumvention of the tax haven income rules. Without this rule, a U.S. corporation can, for example, reduce its U.S. tax by having its second-tier foreign subsidiary (that earns passive income) pay interest to the first-tier foreign subsidiary of the U.S. corporation (the parent of the second-tier corporation). The original purpose of this rule was to prevent penalizing foreign business operations that use more than one controlled foreign corporation in a country. The proposal would not appear to conflict with legitimate operations.

Definition of related party

Expansion of the definition of related party for the purpose of the tax haven income rules to include partnerships, trusts, and other entities as well as corporations would treat very similar entities in a similar way. It would treat, for example, some royalty payments to a related partnership as tax haven income. Its principal effect, however, might be to impose current U.S. tax on arrangements designed primarily to reduce foreign tax rather than U.S. tax. Some taxpayers contend that the United States should not object to arrangements that reduce foreign tax.

Thresholds for applying rules applicable to tax haven income

Vote or value

Proponents of legislation to impose current tax on tax haven income when a foreign corporation is U.S.-owned by either vote or value argue that the present rules allow abuse. In particular, they argue that the present controlled foreign corporation rules, which look only to vote, allow abuse. They point to tax plans where a U.S. person owns a minority of voting stock in a foreign corporation but owns much of the value in the corporation in the form of nonvoting preferred stock. They note that Congress amended the consolidated return rules in 1984 to consider vote and value because of a percep-

tion that taxpayers could manipulate a single factor test. Some argue that while the present rules are generally appropriate, Congress could improve those rules by imposing current tax when 50 percent or more (rather than more than 50 percent) of vote or value belongs to U.S. persons.

Opponents of a vote or value rule argue that ownership of voting power, not value, allows taxpayers to combine to compel a dividend with which to satisfy tax liability on deemed income. They argue that the law already contains rules that consider voting power (in the controlled foreign corporation rules of subpart F) and value (in the foreign personal holding company rules) in determining whether income is eligible for deferral. They argue that some abuse cases, which run afoul of both these sets of rules, already face voting power and value thresholds. They also contend that while a voting power test may be easy to apply, a value test would require inherently difficult valuation questions, the answers to which might vary from year to year. However, these questions arise now for foreign personal holding companies. It is not clear why a value test should apply only in the passive investment case, althoug passive assets may be easier to value than assets generally.

Extending tax haven income rules to any 10-percent shareholder

Advocates of extending the tax haven income rules to any 10-percent U.S. shareholder of a foreign corporation, whether or not the foreign corporation is a controlled foreign corporation, argue that such an extension would prevent circumvention of the current rules. They contend that the current 50-percent U.S. ownership threshold presents opportunities for U.S. taxpayers to defer tax on tax haven income. They note that 10-percent ownership is all that is required for a U.S. shareholder to credit foreign taxes paid by a foreign corporation when the shareholder receives a dividend from the corporation. The existence of this lower 10-percent threshold, they argue, indicates that taxpayers can obtain adequate information about the activities of a 10-percent owned foreign corporation, whatever the aggregate level of U.S. ownership. Opponents of an extension of the tax haven rules to foreign corporations that are not more than 50-percent U.S. owned argue that information about the precise composition, under complicated U.S. concepts, of the income of a foreign corporation in which they have only a minority interest may be more difficult to obtain than information about the amount of its earnings and the taxes it paid. In addition, they argue that this extension would violate the principle that tax should be due only when taxpayers are able to pay it. They note that the present 50-percent U.S. ownership test allows U.S. taxpayers, acting in concert, to vote to compel a dividend (from the foreign corporation whose shares they own) with which to pay the tax the United States assesses. They contend that a lower threshold would cause U.S. tax in cases where taxpayers could not obtain funds to pay it without liquidating their investment. They also argue that the current 50-percent U.S. ownership threshold imposes current tax only when U.S. shareholders are in a position to direct the foreign corporation's activities with a view to avoiding U.S. tax.

De minimis rule

Advocates of change in the 10-percent of gross income de minimis rule contend that the gross income test allows taxpayers to defeat the purpose of the provision because they can earn a substantial amount of tax haven gross income (such as interest) offset by few expenses and yet not violate the 10-percent test if they also earn substantial non-tax haven gross income fully or nearly offset by expenses. (For example, a manufacturing business generates a substantially greater amount of gross income than of net income; a bank account may generate equal amounts of gross and net income.) They contend that a de minimis rule based on net income or earnings and profits would be administrable, as many taxpayers must now calculate these amounts for their foreign subsidiaries. Opponents of change in the gross income de minimis rule argue that the present rule is very easy to administer, especially since it does not require allocation of deductions, a complicated step. In addition, a change could result in current taxation of amounts that appear de minimis, for example, when a foreign subsidiary has a small net loss from business operations and a slightly larger amount of tax haven income.

A fixed dollar de minimis rule, while it might prevent abuse, might be difficult to administer. It might require rules aggregating the tax haven income of commonly controlled foreign subsidiaries, for example. It could only supplement, rather than replace, the existing de minimis rule or a substituted de minimis rule based on net income.

B. Ordinary Income Treatment When Taxpayers Surrender Stock in Foreign Corporations

Present Law

The deferral privilege frequently allows a U.S.-controlled foreign corporation to accumulate foreign earnings free of U.S. tax. The U.S. tax (if any) on deferred earnings is due after the income comes home to the United States. Ordinary income rates apply. Ordinary income treatment also applies when a U.S. shareholder disposes of stock in a present or former controlled foreign corporation that has accumulated earnings that have remained free of U.S. tax (Code sec. 1248). In that case, the Code divides net gain into two categories: (1) accumulated untaxed earnings, taxed at ordinary income rates, and (2) the rest of the gain, if any, taxed at capital gains rates. If accumulated untaxed earnings exceed the gain on the disposition, the entire gain (and nothing but the gain) is taxed at ordinary income rates. This last rule is known as the "gain limitation" rule, because the amount taxed at ordinary income rates is limited to the amount of the gain. Similar rules apply on disposition of a U.S. corporation that owns one or more foreign corporations.

The sale of a foreign corporation with unrealized ordinary income, however, generally invokes U.S. tax at capital gains rates, not ordinary income rates. For instance, assume a controlled foreign corporation's assets include unsold inventory or rights to payment for goods or services already furnished. Assume further that the foreign corporation has no accumulated earnings (under U.S.

rules) and is not subject to the collapsible corporation rules (e.g., because 70 percent or less of the gain on sale of the shares of the foreign corporation is attributable to designated assets). In such a case, the United States imposes tax on the U.S. shareholder's gain from the sale of its shares in the foreign corporation at capital gains rates. The same capital gain treatment would apply to the sale of shares of a U.S. corporation.

Administration Proposal

The Administration proposal would allow individuals to index the basis of capital assets beginning in 1991. The proposal does not refer specifically to foreign corporations.

Other Proposals

1. S. 409 and H.R. 800 (Bradley-Gephardt) would repeal the preferential capital gains rate generally.
2. H.R. 2222 and S. 1006 (Kemp-Kasten) would generally allow indexation of the basis of capital assets, but would not do so for stock of foreign corporations generally.
3. H.R. 1377 (Stark) would reduce the benefits of the capital gains rate by 20 percent; S. 556 (Chafee) would reduce those benefits by 15 percent.

Other Possible Proposals

1. One proposal would be to treat all gains from dispositions of foreign corporations as ordinary income.
2. Another proposal, suggested in a tentative draft submitted to the American Law Institute,[4] would repeal the gain limitation on disposition of shares of foreign corporations. For example, assume that a U.S. corporation owns all the shares of a foreign corporation. The U.S. corporation has a basis of $100 in those shares. The foreign corporation has accumulated untaxed earnings of $70. The U.S. corporation sells all its shares in the foreign corporation for $120. Under current law, the U.S. corporation would be taxable on $20 of ordinary income. Under this proposal, the U.S. corporation would be taxable on $70 of ordinary income, but would have a $50 capital loss.
3. Another possible proposal would be to treat the gain from the sale of a controlled foreign corporation as ordinary income to the extent that it holds unrealized income attributable to ordinary income assets (so-called "hot assets"). For the definition of ordinary income assets, the definition that applies for a similar purpose in the Code partnership provisions could be used.

Analysis

If the Administration proposal would in fact index the basis of the stock of a foreign corporation, that treatment could allow indi-

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[4] Tentative Draft #14, referred to in the text, is a working paper which has not been approved by the Members of the American Law Institute and does not represent the position of the Institute on any of the issues with which it deals.

viduals to avoid all tax on some earnings of foreign corporations that have not borne tax.

Repeal or reduction of capital gain treatment

Some suggest that the main reasons for the preferential capital gains rate do not apply to sales of stock of foreign corporations. One reason advanced for the capital gains rate is that it provides an incentive for capital investment. It is not clear that the United States should provide an incentive for foreign capital investment generally or for ownership of foreign corporate shares in particular. Another reason advanced for the application of the capital gains rate on sales of corporate stock is that it ameliorates the double (two-tiered) taxation of corporate earnings. Capital gains treatment is a crude means of mitigating double taxation, however, and foreign corporate earnings may not be subject to two tiers of U.S. taxation.

Some of the reasons for the preferential capital gains rate do apply to sales of foreign corporate stock, however. To the extent that the capital gains rate prevents taxation of nominal gains that arise because of inflation, it is just as important for sales of foreign assets. Another argument for a preferential rate is that it prevents a "lock in" effect, that is, without a preferential rate, taxpayers would retain assets that they wish to sell. The lock in effect would prevent the best allocation of capital.

The arguments against a reduced tax on capital gains apply generally to foreign assets. In particular, imposition of tax at ordinary income rates on the sale of shares of a controlled foreign corporation would simplify the tax law considerably for some transactions.

Repeal of gain limitation

Imposition of tax at ordinary income rates on accumulated earnings of a controlled foreign corporation when they exceed the gain on the disposition of the corporation would prevent taxpayers from paying less ordinary income tax because of a change in the value of assets. Arguably, the deferral of taxation does not justify a netting of ordinary income and capital loss. This proposal would eliminate part of the advantage of deferral (discussed in Part A., above), however, so advocates of deferral would tend to oppose this proposal. Moreover, in some cases the proposal might impose tax on a transaction from which the taxpayer derived no income with which to pay tax. In such cases, a new kind of lock in effect might arise

"Hot assets" proposal

This proposal would prevent the use of foreign corporations to let taxpayers pay tax at the lower capital gains rates when they arguably should pay tax at ordinary income rates. It would add some complexity to the tax law, however. Moreover, it would treat some sales of foreign corporations more harshly than sales of similar U.S. corporations. Arguably, Congress should broaden the collapsible corporation rules to address this problem.

C. Foreign Investment Companies

Present Law and Background

Generally, no current U.S. tax applies to the foreign income of a foreign corporation that is not a "controlled foreign corporation" or a "foreign personal holding company," even if all its income is passive income or other tax haven income, and even if all its shareholders are Americans. When a U.S. person disposes of stock in a "foreign investment company," however, the gain is not automatically subject to a favorable capital gains tax rate, even if the company is widely held. The gain is subject to ordinary income treatment to the extent of the shareholder's share of the foreign investment company's earnings and profits (Code sec. 1246). To the extent that that share of earnings and profits exceeds the gain on disposition, only the gain is taxed at ordinary income rates (this is the "gain limitation" rule). The foreign investment company rules generally apply to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities or commodities or interests in either when 50 percent or more of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons.

Administration Proposal

The Administration proposal would allow individuals to index the basis of capital assets beginning in 1991. The proposal does not refer specifically to foreign investment companies.

Proposals

1. S. 409 and H.R. 800 (Bradley-Gephardt) would repeal the preferential capital gains rate generally.
2. S. 411 and H.R. 373 (Roth-Moore) would generally repeal the preferential capital gains rates for individuals.
3. H.R. 222 and S. 1006 (Kemp-Kasten) would generally allow indexation of the basis of capital assets, but would not do so for stock of foreign corporations generally.
4. H.R. 1377 (Stark) would reduce the benefits of the capital gains rate by 20 percent; S. 556 (Chafee) would reduce those benefits by 15 percent.

Other Possible Proposals

1. One possible proposal, suggested by a tentative draft submitted to the American Law Institute,[5] would give a U.S. owner of stock in a foreign investment fund, whatever the degree of aggregate U.S. ownership, an election: to pay tax currently on his share of the foreign fund's passive income, or to pay tax at ordinary income rates on eventual distribution or disposition, but increased by an

[5] Tentative draft #14, referred above, is a working paper which has not been approved by the Members of the American Law Institute and does not represent the position of the Institute on any of the issues with which it deals.

interest charge for the period from the year when the income was derived to the year when tax became due.

2. A more limited proposal would be to impose tax at ordinary income rates on dispositions of interests in foreign investment funds, whatever the degree of aggregate U.S ownership.

3. Another proposal would be to repeal the gain limitation rule for dispositions of foreign investment company shares.

Analysis

If the administration proposal would in fact index the basis of the stock of a foreign investment company, that treatment could allow individuals to avoid all tax on some earnings of a foreign corporation that have not borne tax.

The foreign investment rules do not operate absent what is arguably an arbitrary degree of U.S. ownership. The current rules allow taxpayers two advantages: (1) deferral on passive income they earn on liquid assets, and (2) absent enough U.S. ownership, conversion of the ordinary income to capital gain.

Deferral of tax on passive income of foreign investment funds gives U.S. taxpayers an incentive to put liquid assets in widely held foreign corporations rather than in U.S. investments. However, U.S. taxpayers investing in foreign investment funds, at least those whose owners are mostly foreign, may not be able to compel the distribution of dividends with which to pay tax, so current taxation of a pro rata portion of those fund's earnings might violate the "ability to pay" principle.

Some argue that the United States should not allow capital gain treatment to any U.S. investor earning passive income through a foreign investment fund, whatever the aggregate level of U.S. ownership in the fund or company might be.

One argument militates against both current taxation and ordinary income treatment: that U.S. shareholders in foreign corporations without 50-percent U.S. ownership may not know fully what the company is doing, and that they cannot always determine whether the corporation is a foreign investment company in that case. The lower the U.S. ownership level, the harder it may be to obtain adequate data, so some new threshold (lower than 50 percent) might be appropriate. One response to this "shareholder ignorance" argument is a presumption of disbelief that shareholders do or would invest in a foreign corporation without knowing whether the corporation is engaged in passive investing or active business. Even if the shareholders know generally what the corporation is doing, however, they may not have enough information to calculate their share of currently taxable earnings.

The arguments discussed in B., above, with respect to the gain limitation rule for corporate shareholders, generally apply to the analogous situation of individual shareholders, also.

III. FOREIGN TAX CREDIT

A. In General

Present Law and Background

The United States taxes U.S. persons[6] on their worldwide income, including their foreign income. Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being fully taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States. The foreign tax credit allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income. The credit may not reduce the U.S. tax on U.S. income. The latter limitation is known as the foreign tax credit limitation.

A foreign tax credit is allowed for foreign taxes paid on income derived from direct operations (conducted, for example, through a branch office) or passive investments in a foreign country. A credit also is allowed with respect to dividends received from foreign subsidiary corporations operating in foreign countries and paying foreign taxes. The latter credit is called a deemed-paid credit or an indirect credit.

The foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income earned from the activity, even though the income is received by a corporation or individual resident in another country. Under this principle, the home country of the individual or corporation has a residual right to tax the income earned from the activity, but undertakes to prevent international double taxation of that income. Some countries avoid such double taxation by exempting foreign income from tax. However, most countries, including the United States, avoid international double taxation by providing a dollar-for-dollar credit against home country tax on foreign income for foreign income taxes paid on foreign income.

The U.S. foreign tax credit is elective. Taxpayers who prefer may deduct foreign taxes instead, though most taxpayers benefit more by claiming the credit. Taxpayers may not mix methods in any one year, that is, a taxpayer who chooses to credit any foreign taxes in a year may not deduct other foreign taxes paid that year. The reason that Congress requires taxpayers either to deduct all foreign taxes or to credit all foreign taxes is that allowing a deduction for the amount of taxes not credited would reduce the U.S. tax on U.S. income (see discussion in B., below).

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[6] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates.

Sections B. through F., below, discuss in detail the foreign tax credit limitation, the income sourcing rules, the deemed-paid credit, the foreign levies for which a credit is allowed, and the treatment of losses for credit purposes.

Administration Proposals

Administration proposals (and others) regarding the foreign tax credit limitation, the source rules, the deemed-paid credit, and the treatment of losses for credit purposes are described in B., C., D., and F., below.

General Analysis

As indicated above, the purpose of the foreign tax credit is to reduce international double taxation. All industrialized countries provide some relief from such double taxation through either a credit, an exemption for foreign income, or both. The credit reflects the internationally accepted principle that the country in which a business activity is conducted has the first right to tax the income earned from that activity. That principle is based on a recognition that the country where income is earned provides the environment for the earning of that income. Those favoring the credit system argue that the credit helps to create tax neutrality between foreign and U.S. investment. Although U.S. taxpayers earning foreign income may supply less revenue to the U.S. Treasury than if they earned U.S. income under a credit system, such taxpayers ultimately pay total income taxes (to the U.S. Government and to foreign governments) that equal or exceed what they would pay on U.S. income, assuming that all their foreign income is eventually repatriated and, thus, is subjected to U.S. tax. Therefore, it is argued, the credit generally does not discriminate in favor of those taxpayers. Without the credit, U.S. taxpayers earning foreign income would sometimes pay higher combined taxes than either foreigners earning foreign income or U.S. taxpayers earning domestic income. This, it is argued, would seriously impair their competitive position.

Some argue, however, that the present U.S. rules for taxing foreign income of U.S. persons, taken together—in particular, the credit, the overall foreign tax credit limitation, and the deferral of U.S. tax on the unrepatriated earnings of foreign subsidiaries—create a bias against domestic investment. That bias, it is argued, would be increased under the Administration proposal (because of the proposed elimination of some domestic tax incentives that generally are not presently available for property used predominantly outside the United States) absent some of the changes in the foreign tax credit rules proposed by the Administration. Eliminating the credit, or limiting it to some fraction of foreign taxes paid, some suggest, would be one way to reduce or eliminate this bias. Other argue that foreign income taxes should be treated for U.S. tax purposes like other business expenses generally are treated, that is, they should be deductible only. Further, it has been suggested that the arguments advanced in favor of the Administration proposal to eliminate the itemized deduction for State and local income taxes conflict with the rationale for the foreign tax credit.

Those favoring the credit system respond that it is inappropriate to determine tax policy with respect to foreign taxes based on an analogy between foreign taxes and State and local taxes. State and local governments are not independent sovereign entities. Foreign governments are. Foreign governments are thus comparable to the U.S. Federal Government rather than to State and local governments. Therefore, it is argued, foreign taxes are comparable to taxes paid to the U.S. Federal Government and are properly creditable against U.S. taxes. Others point out, however, that a foreign tax credit generally is provided for subnational foreign taxes as well as national foreign taxes. They argue that an analogy between subnational foreign taxes and State and local taxes may properly be drawn for tax policy purposes.

Advocates of the credit also point out, however, that elimination or reduction of the credit would be inconsistent with international norms of taxation and could lead to retaliatory denial by foreign governments of foreign tax credits for U.S. taxes paid by foreign companies operating in the United States. Elimination of the credit also would conflict with U.S. income tax treaty obligations, they suggest.

B. Foreign Tax Credit Limitation

Present Law and Background

In general

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. income, only a taxpayer's U.S. tax on its foreign income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned in the United States.

The tax law imposes a limitation (first enacted in 1921) on the amount of foreign tax credits that can be claimed in a year that prevents a taxpayer from using foreign tax credits to offset U.S. tax on U.S. income. This limitation generally is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide taxable income (U.S. and foreign taxable income combined) between its U.S. and foreign taxable income. The ratio of the taxpayer's foreign taxable income to its worldwide taxable income is multiplied by the taxpayer's total pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign income and, thus, the upper limit on the foreign tax credit for the year.

Overall and per country limitations

Historically, the foreign tax credit limitation has been determined on the basis of total foreign income (an "overall" limitation or method), foreign income earned in a particular country (a "per country" limitation or method), or both.

Under an overall method, the taxpayer adds up its net income and net losses from all sources outside the United States and allocates its pre-credit U.S. tax based on the total. An overall method provides "averaging" for limitation purposes of the income and losses generated in, and the taxes paid to, the various foreign countries in which a taxpayer operates and other income and losses

sourced outside the United States, such as those generated from shipping activity. Averaging of income may benefit a taxpayer. For example, a taxpayer doing business in several foreign countries can credit high taxes paid to one or more of those countries against its pre-credit U.S. tax on income earned in another of those countries that is lightly taxed by the latter country and, thus, would bear U.S. tax absent the excess foreign tax credits. Averaging of losses, on the other hand, may not benefit a taxpayer. For example, a taxpayer obtains no tax savings from a net loss incurred in one foreign country when the loss is averaged with income earned in a second foreign country if the total foreign taxes paid on the income from the second country exceed the pre-credit U.S. tax on it. In that case, because of the foreign tax credit, the income would be free of U.S. tax even if the loss were not averaged with it.

Under a per country method, the taxpayer calculates the foreign tax credit limitation separately for each country to which it earns income. The foreign income taken into account in each calculation is the foreign income derived from the foreign country for which the limitation is being determined. Otherwise, a per country limitation is calculated in basically the same manner as an overall limitation.

Under a per country limitation, foreign taxes paid on income from sources within any particular foreign country can be used as credits by the taxpayer only against that portion of its total pre-credit U.S. tax that is allocable to that income. Thus, a per country limitation restricts the averaging of income earned in different foreign countries. Under prior law per country rules, some inter-country averaging could continue to be achieved through the use of a foreign holding company because earnings and taxes were not traced through tiered entities located in different foreign countries. For example, a U.S. corporation could interpose a first-tier Bermudan corporation as the parent of second-tier subsidiary corporations incorporated and operating in Germany (a high-tax country) and Panama (a low-tax country), respectively. The taxes paid by the German and Panamanian subsidiaries were carried along (under the deemed-paid credit) with any dividends paid to their Bermudan parent. When the Bermudan company in turn paid a dividend to its U.S. owner, the dividend was treated as coming out of Bermudan earnings and the taxes paid by the German and Panamanian subsidiaries were combined and treated as if the Bermudan company had paid them.

Under prior law per country rules, a taxpayer first used the entire amount of a net loss incurred in any foreign country to reduce its U.S. taxable income. No reduction was later required in the amount of foreign tax credits that could be claimed against the U.S. tax on income subsequently earned in the loss country.

From 1921 until 1932, an overall limitation was in effect. Between 1932 and 1954, foreign tax credits were limited to the lesser of the overall or per country limitation amount. In 1954, Congress amended the law to allow only a per country limitation. From 1960 to 1975, Congress permitted taxpayers to elect between an overall and a per country method. Since 1976, an overall limitation has been mandatory.

Most countries that use a foreign tax credit to reduce international double taxation impose a per country limitation on the credit. To the staff's knowledge, none of these countries requires for limitation purposes that earnings or taxes be traced through tiered entities.

Separate limitations

Under present law, the overall foreign tax credit limitation is calculated separately for DISC dividends, FSC dividends, taxable income of a FSC attributable to foreign trade income, and certain interest income, respectively. Also, a special limitation applies to the credit for taxes imposed on oil and gas extraction income. The tax law sometimes disregards intermediate entities to apply these limitations correctly.

In general, a separate limitation is applied to a category of income for one of three reasons: the income's source (foreign versus U.S.) can be manipulated, the income typically bears little or no foreign tax, or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the averaging of that income, and the foreign taxes paid on it, with other types of income, and the foreign taxes paid on the latter income. Under the separate limitation for interest, for example, high foreign taxes paid on active business income generally do not reduce the U.S. tax on passive interest income that is lightly taxed abroad. Separate limitations help to preserve the U.S. tax on categories of foreign income that frequently bear little or no foreign tax.

Per item limitation

Under a per item foreign tax credit limitation, which has never been in effect in the United States, foreign taxes paid on income earned from a particular transaction could only be credited against the U.S. tax on that income. Thus, a per item limitation would prevent the averaging of income and taxes with respect to different transactions, including transactions that take place in the same foreign country or generate the same type of income.

Excess credits and excess limitation

Excess foreign tax credits result when the amount of foreign creditable taxes paid on certain income in a given year exceeds the foreign tax credit limitation applicable to that income. Excess limitation results when the amount of foreign creditable taxes paid on certain income in a given year is less than the foreign tax credit limitation applicable to that income.

Foreign tax credit carryback and carryover

Excess foreign tax credits may be carried back successively to the second and first taxable years preceding the year in which they arise, and then forward to the first, second, third, fourth, and fifth succeeding taxable years. The credits so carried are deemed paid in the earlier or later years and may be used in such years to the extent that creditable foreign taxes actually paid in such years do not equal or exceed the applicable foreign tax credit limitation.

Under this rule, current foreign taxes are credited against U.S. tax before foreign taxes carried from other years are credited against U.S. tax.

Congress enacted the foreign tax credit carryback and carryover in 1958 to eliminate the double taxation that sometimes resulted when a method of reporting income in a foreign country differed from the method in the United States. This may result in reporting the same income in one year in the United States and in another year in the foreign country. When this occurs, the limitation on the foreign tax credit tends to be less than the taxes paid to the foreign country in the year the income is reported in that country but not in the United States. In another year when this income is reported in the United States but not in the foreign country, the limitation on the credit tends to exceed the foreign taxes paid.

Administration Proposal

The Administration proposal would replace the overall foreign tax credit limitation with a per country limitation.

Under the per country rules proposed, a net loss incurred in one foreign country would reduce income derived from all other countries, including the United States, on a pro rata basis, rather than income derived from the United States alone. (The proposed rules governing losses are discussed further in F., below.) For limitation purposes, earnings and taxes would be traced through tiered entities located in different foreign countries: Net income taxes generally would be treated as taxes of the countries to which they were paid, and dividends from foreign subsidiaries that earned at least 10 percent of their accumulated profits in third countries would be "re-sourced" to the countries from which the subsidiaries derived the profits out of which the subsidiaries paid the dividends. Any gross basis withholding taxes imposed by foreign subsidiaries' residence countries on their re-sourced dividends would be allocated to the re-sourced dividends. In addition, a foreign subsidiary would be able to elect to have a portion of other residence country taxes allocated to the re-sourced dividends as well if the subsidiary was subject to worldwide net income taxation in its residence country and derived more than 10 percent of its income outside its residence country.

The Adminstration proposal generally would retain the present law separate limitations, but would apply them on a country-by-country basis. The application of the separate limitation for certain interest would be extended to gains on the disposition of certain assets that generate passive income and dividends from companies in which the taxpayer holds less than a 10-percent interest. Under tracing rules similar to those enacted in the Tax Reform Act of 1984 for certain income derived from 10-percent U.S.-owned foreign corporations and regulated investment companies (sec. 904(d)(3)), dividends generally would be subject to the various separate limitations on a pro rata basis. For example, 10 percent of a dividend from a foreign subsidiary would be subject to the new separate limitation for passive income if 10 percent of the subsidiary's accumulated profits were attributable to income of the type subject to that separate limitation. While the special limitation for foreign taxes

on oil and gas extraction income would be retained (sec. 907(a)), the general rules for computing the per country limitation, including the rules relating to loss allocation, would apply to taxpayers in the oil and gas industry. (See F., below.)

The Administration proposal also would extend the foreign tax credit carryover period from five to 10 years and permit taxpayers to make the election to deduct or to credit foreign taxes on a country-by-country basis.

Other Possible Proposals

1. Extend the application of the separate limitation for interest to gains on the disposition of certain assets that generate passive income and dividends from companies in which the taxpayer holds less than a 10-percent interest, as the Administration has proposed, and, in addition, to other types of passive income, including certain commodities gains, insurance premiums, rents, and royalties.
2. Retain the overall limitation but establish a separate limitation for income lightly taxed abroad.
3. Replace the foreign tax credit carryback with an excess limitation carryover.

Analysis

Per country limitation versus overall limitation

International double taxation and a per item limitation

The Administration and others argue that separate calculations of the foreign tax credit limitation for each item of foreign income would provide full relief from international double taxation of that income. Under such a per item limitation, foreign taxes paid on income earned from a particular transaction could only be credited against the U.S. tax on *that income*. Because a per item limitation would prevent any averaging of foreign income and taxes with respect to different transactions, it would be more restrictive than an overall or per country limitation or a separate limitation for a particular category of income.

Some question the argument that a per item limitation would fully relieve international double taxation. That argument, they suggest, assumes that the concept of international double taxation has one specific meaning, namely, taxation by both the United States and a particular foreign country of income earned in that foreign country from a particular transaction. They argue that the logic of the foreign tax credit does not dictate one particular meaning for the concept for international double taxation. They note the different meanings of the concept implicit in a per country and an overall limitation: taxation by both the United States and a particular foreign country of total income from that foreign country, in the case of a per country limitation, and taxation by both the United States, on the one hand, and all foreign countries, on the other, of total income from outside the United States, in the case of an overall limitation. They argue that either a per country or an overall limitation could be more conceptually correct than a per item limitation, depending upon one's concept of international double taxation.

Probably the strongest argument against a strict per item limitation is that its administration would likely be too burdensome for such a limitation to be practical. Under a strict per item limitation, taxpayers would have to calculate the foreign tax credit limitation separately for each of their foreign income-producing transactions. While this would be time-consuming even if it could be done easily, partitioning business activity into discrete transactions and allocating net foreign income among such transactions in fact could prove very difficult in many cases. Furthermore, taxes are not ordinarily levied on a transaction-by-transaction basis.

Averaging

As discussed above, a per country foreign tax credit limitation would limit the averaging of income earned in, and taxes paid to, different foreign countries that the present overall limitation permits. Unlike a per item limitation, it would not prevent the averaging of income earned and foreign taxes paid on different transactions conducted within a single country. (However, it should be noted that the expanded application proposed by the Administration of the separate limitation for interest to certain dividends and passive gains, coupled with the continued application of that limitation on a per country basis, would reduce such intracountry averaging.) Those who believe that the averaging of foreign income and taxes for limitation purposes should be limited argue that the Administration proposal represents a compromise between competing policy goals: limiting such averaging, on the one hand, and limiting the administrative complexity of the limitation rules, on the other.

The principal arguments advanced by the Administration and others for limiting the averaging permitted under the overall limitation are: First, when high foreign taxes paid to one foreign country offset U.S. tax on income earned in another foreign country that bears a foreign tax below the U.S. tax, the United States surrenders its residual right to tax the latter income. Second, U.S. taxpayers with excess foreign tax credits from operations in high-tax countries have an incentive to place new investments in low-tax countries rather than in the United States since they can use the excess credits to reduce or eliminate the U.S. tax on their income from investments in low-tax countries. This incentive would become more pronounced if U.S. corporate tax rates are reduced as the Administration has proposed because lower U.S. rates (relative to foreign rates), it is argued, would cause more taxpayers to operate in excess credit positions. Third, the relative balance of tax rules favoring U.S. investment and tax rules favoring foreign investment could be tilted somewhat in favor of foreign investment by certain features of the Administration proposal, for example, the proposed elimination of the investment tax credit and accelerated cost recovery system (ACRS), which are not generally available for property used predominantly outside the United States; limiting averaging, it is argued, would counteract any such effect. Fourth, the averaging allowed under the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment. Under the overall limitation, it is argued, U.S. companies with operations in low-tax countries can invest in high-tax countries without bearing the full

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burden of the high taxes. Instead, the U.S. Treasury bears that tax burden to the extent of the United States' claim to a residual tax on the income earned in the low-tax countries.

Opponents of the Administration proposal respond that any incentive provided by the overall limitation to make new investments abroad rather than in the United States is relatively insignificant because decisions regarding what country to place a new investment in generally are influenced by considerations much broader than tax matters. Important non-tax considerations cited include relative labor costs, access to markets, the location of raw materials, transportation costs, customs duties, political stability, government regulations, domestic content requirements, and exchange controls. In any case, however, they point out, a per country limitation would not reduce any incentive that might presently exist to place investments abroad rather than in the United States in a case where the taxpayer pays high foreign taxes (giving rise to excess credits) on certain income earned in a particular country, but can obtain a low rate of tax on income earned on a new investment placed in that same country. They also argue that, if U.S. corporate tax rates are reduced, as the Administration has proposed, the number of foreign countries that are low-tax countries relative to the United States will also be reduced and, thus, there will be fewer foreign countries that, from a relative tax rate perspective, might be more attractive than the United States to place a new investment in.

Supporters of the Administration proposal acknowledge that decisions regarding where to invest may be influenced by a variety of non-tax considerations; in their view, however, that does not render less significant the incentive to invest abroad provided by the overall limitation to taxpayers who have or expect to have excess foreign tax credits. They point out that, according to traditional microeconomic analysis, incentives operate "at the margin." Thus, a U.S. taxpayer attempting to choose between a U.S. and a foreign investment that remains indifferent after the usual business considerations have been taken into account will make the foreign investment if a tax incentive (or additional non-tax incentive) to do so is introduced. In any event, proponents of the Administration proposal point out that taxpayers have frequently stated that tax rules *do* play an important role in their decisions regarding whether to invest at home or abroad. The House Committee on Ways and Means recently received testimony, for example, contending that the proposed repeal of the investment tax credit and ACRS, coupled with certain other tax rules, would provide a positive incentive for U.S. companies to manufacture goods abroad that would likely result in a flood of overseas investment. As another example, some opponents of the Administration proposal to replace the possession tax credit with a wage credit argue that many U.S. companies currently operating in Puerto Rico and claiming the possession tax credit would move their Puerto Rican operations elsewhere if that credit were repealed.

In response to the point that a per country limitation would not reduce any incentive that might now exist to place new investments in a foreign country to which the taxpayer already pays high foreign taxes and from which the taxpayer can obtain a low

rate of tax on new investments, those favoring the Administration proposal suggest that these opportunities are relatively uncommon; that, in most cases, the foreign investment incentive in question operates with respect to potential investments in third countries that are low-tax overall; and that the proposal would eliminate the incentive in those cases.

Those opposing the Administration proposal also argue, however, that, for several reasons, the averaging of foreign income and taxes allowed under the overall limitation is necessary and appropriate. First, many U.S. companies do not have separate operations in each foreign country where they do business but rather have an integrated structure that covers all their overseas operations or all their operations in a particular region (such as Western Europe). Advocates of the Administration proposal respond that the manner in which U.S. companies structure their foreign operations (or, for that matter, their U.S. operations) cannot always be allowed to dictate how those operations are taxed. Opponents of the proposal argue further, however, that the purpose of the foreign tax credit limitation is to prevent foreign taxes from being used to reduce the U.S. tax on U.S. income and that purpose is not undermined by the averaging in question; the present overall limitation does not permit taxpayers to use foreign tax credits to reduce the U.S. tax on their U.S. income. Advocates of the proposal counter that another purpose of the foreign tax credit limitation is to prevent misuse of the credit more generally; the present law separate limitations, for example, perform that function. Also, they argue, the purpose of the foreign tax credit itself—relieving international double taxation—is not served by averaging; that is, as argued above, such double taxation can be alleviated without averaging being permitted. A third argument made in defense of averaging is that all countries using a credit system, including those that impose a per country limitation, permit some intercountry averaging of income and taxes; the proposed tracing rules, which are designed to prevent taxpayers from using a foreign holding company to obtain intercountry averaging, have no precedent anywhere. In response, proponents of the Administration proposal point out that the U.S. tax system generally is more advanced then those of most countries. The United States is the largest country in the world in economic terms and has frequently pioneered anti-abuse rules which other countries later adapted for their own use (for example, the anti-tax haven rules of subpart F of the Code).

A fourth argument for averaging is that it helps mitigate the double taxation that sometimes arises when a method of reporting income or expense in a foreign country differs from the method used in the United States and, as a result, the foreign tax credit limitation does not match the foreign taxes actually paid. Proponents of the Administration proposal note, however, that Congress enacted the foreign tax credit carryback and carryover specifically to relieve double taxation arising from differences in U.S. and foreign income reporting rules. They argue that the credit carryback and carryover provide a more focused solution to the problem of reporting rule differences than averaging does and point out that the Administration proposal would extend the carryover to 10 years. A fifth argument for averaging is that it mitigates problems caused

by arbitrariness in the rules governing the source of income and the allocation and apportionment of deductions. A sixth argument for averaging is that it is necessary to keep U.S. companies' worldwide tax rates on foreign income down to the U.S. rate. In response to this sixth argument, it is asserted, however, that the foreign tax credit's purpose is not to reduce to the U.S. rate the worldwide rate of tax on foreign income of U.S. companies. If a U.S. company chooses to operate in a foreign country that imposes a higher tax on its income than the United States would impose, then that company, and not the U.S. Treasury, should bear the burden of the excess.

Competitive impact of per country limitation

Opponents of the Administration proposal argue, in addition, however, that it would weaken the competitive position of U.S. companies operating abroad vis-a-vis their foreign counterparts operating abroad. Most such foreign companies, it is argued, are subject to more favorable tax regimes at home than their U.S. competitors are; a per country limitation with tracing rules like those proposed by the Administration would increase the competitive advantage already enjoyed by some foreign companies. Opponents assert that the proposed per country limitation system would be stricter than any foreign country's system for taxing foreign income. Some opponents contend that the purpose of the foreign tax credit is not to eliminate international double taxation alone, but also to promote the international competitiveness of U.S. business. They argue that foreign investment by U.S. businesses should be encouraged because it increases U.S. jobs, exports, and tax revenues, and improves the trade balance, and that a per country limitation would have an adverse impact in each of these areas. In addition, the Administration proposal, it is argued, would force U.S. businesses to forego investment opportunities in high-tax countries and concentrate their foreign investments in low-tax countries; it would thus make taxes a more important rather than less important factor in foreign investment decisions.

Those favoring the Administration proposal respond that *any* change in U.S. tax law that might increase one business' tax but not a competitor's arguably could weaken the first business' competitive position; they argue that the competing tax policy goals favoring a proposed change must, in every case, be given adequate weight. In any event, they argue, some U.S. companies operating abroad may be subject to lower overall tax burdens at home than their foreign competitors because of the high taxes other than income taxes (for example, value-added taxes) imposed by some foreign countries and the less favorable expensing rules for income tax purposes in some foreign countries. They also point out that the proposed per country election to deduct or to credit foreign taxes, extension of the foreign tax credit carryover period, and U.S. loss recapture rule (discussed below) all would mitigate the loss of credits resulting from a shift to a per country regime.

Those favoring the Administration proposal disagree that a shift of some U.S. investment from high-tax to low-tax foreign countries would be undesirable. On the contrary, a problem with the overall limitation, they point out, is that it makes some U.S. companies in-

different to high foreign taxes. The averaging of foreign income and taxes permitted under the overall limitation sometimes allows U.S. companies to transfer the burden of high foreign taxes from themselves to the U.S. Treasury. It is the incentive to shift U.S. investment from the *United States* to low-tax foreign countries under an overall limitation, not the incentive to shift U.S. investment from high-tax to low-tax foreign countries under a per country limitation, that is undesirable, proponents of the Administration proposal claim. Opponents respond that adoption of the Administration proposal might result in some low-tax countries increasing taxes on U.S. investors. They reason that the elimination of intercountry averaging possibilities for U.S. taxpayers under a per country limitation would render less effective a development strategy some countries now follow—maintaining low tax rates to attract foreign investors. Higher taxes in what are now low-tax countries, opponents argue, would reduce any U.S. tax revenue gain from a shift to a per country regime since it is from increased after-credit U.S. tax on repatriated income that is lightly taxed abroad that such revenue gain would occur. Proponents of the Administration proposal note, however, that increased foreign taxes that are dependent upon the availability of a U.S. foreign tax credit would not be creditable under U.S. creditability rules (see D., below) and, thus, would not have an effect on estimated U.S. tax revenue gains. They also suggest that low-tax countries could not raise taxes on foreign investors without risking a loss of foreign investment from countries other than the United States and, thus, might be reluctant to do so.

The Administration proposal arguably couples an "overall" concept for spreading losses (discussed further in F., below) with a per country limitation on income. Some oppose the proposal on the ground that, while there are both advantages and disadvantages for taxpayers in the use of either an overall or a per country limitation, the proposal arguably adopts selectively the disadvantages of each while eliminating the advantages. The result of coupling an overall concept for spreading losses with a per country limitation on income, they argue, is that, in some cases, fewer foreign tax credits would be available under the proposal than were available under the most restrictive prior law limitation regime—under which credits were limited to the lesser of the overall or per country limitation amount.

Relative administrative burden

Another consideration in comparing an overall and a per country limitation is the relative administrative burden placed by each on taxpayers and on the Internal Revenue Service. As indicated above, a per country limitation requires that a separate limitation calculation be made for each foreign country in which a taxpayer earns income. Thus, a taxpayer must make allocations of gross income and deductions to each of the countries in which it operates, rather than dividing gross income and deductions between U.S. and foreign sources only. Since, as noted above, many U.S. businesses operate abroad on an integrated basis, allocating income and deductions to each of the various foreign countries in which a business operates often could be a complicated process leading to a poten-

tially arbitrary result. Such a per country allocation could constitute a substantial recordkeeping burden for taxpayers and place the Internal Revenue Service in the difficult position of attempting upon audit to review a company's operations in every foreign country. Such administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions generally required is between the United States and all other foreign countries as a group.

Critics of the per country rules proposed by the Administration point out that these rules would surpass in administrative complexity prior law per country rules. Application of the tracing rules, in particular, they argue, generally would require a complex series of factual determinations, re-sourcings of income, and identifications of taxes associated with income when significant amounts were earned by foreign branches or subsidiaries in third countries and distributed through tiers of entities. Under the foreign loss allocation and recapture rules (discussed in more detail in F., below), they point out, a loss allocation would have to take place whenever a net loss was incurred directly in any foreign country, and the taxpayer would have to keep a separate set of loss accounts for every foreign country in which it incurred such net losses. Extending the application of the separate limitation for interest to certain dividends and gains from the sale of passive assets, and applying that separate limitation on a country-by-country basis, would add additional recordkeeping burdens, they argue, by multiplying the number of required separate limitation calculations and allocations of income and deductions. Further complications could result, some suggest, if rules are devised to prevent U.S.-owned foreign subsidiaries operating in low-tax countries from circumventing the per country limitation by lending earnings to affiliated subsidiaries operating in high-tax countries instead of repatriating the earnings directly.

Those favoring the Administration proposal acknowledge that a per country limitation is administratively more complex than an overall limitation. They point out, however, that a type of per country system was administered for many years in the United States. They argue that per country limitation *concepts* are not more complex or difficult than overall limitation concepts; a per country limitation is only more time consuming to administer, they suggest. They acknowledge that the tracing rules proposed by the Administration would introduce complexities not found under prior law per country regimes, but say that these rules are necessary to preserve the integrity of a per country limitation.

Dividend repatriation

Another argument made against a per country limitation is that it discourages the payment of dividends by foreign subsidiaries to their U.S. parents. This is because, under a per country limitation, the repatriation of dividends from high-tax countries may trigger excess foreign tax credits, while dividends repatriated from low-tax countries may bear U.S. tax after the deemed-paid credit is applied. Opponents of the Administration proposal argue that reduced dividend repatriation would result in increased investment of foreign

earnings abroad rather than in the United States and deterioration in the U.S. balance of payments.

Some argue in response that a per country limitation does not discourage the repatriation of dividends from high-tax countries because, once a shift to a per country regime is made, the total tax borne by income of a foreign subsidiary located in a high-tax country is not significantly increased by repatriation of that income: Whether the income is repatriated or accumulated, it bears a high foreign tax and no U.S. tax. Generally, the only difference is the possibility of an additional foreign withholding tax if the income is repatriated. (This possibility also exists under present law.) U.S. tax on the income is eliminated by the foreign tax credit if the income is repatriated and is deferred if the income is accumulated (see discussion of deferral in II., A., above).

History of limitation

Finally, opponents of the Administration proposal assert that an overall limitation has functioned well for the past 25 years. They argue that existing Code provisions, including the rules enacted in 1984 to maintain the character of interest income and the separate foreign tax credit limitations already in place for certain types of low-taxed, high-taxed, and manipulable income, prevent significant abuses of the foreign tax credit limitation. The repeal of the per country limitation in 1976 indicates, they say, that Congress has found it deficient.

Proponents of the Administration proposal respond that the United States has used a per country limitation, an overall limitation, and combinations of the two over the years and has twice before cut back the availability of or repealed an overall limitation (in 1932 and 1954). They call attention to the fact that Congress repealed the pre-1976 per country limitation only because its foreign loss allocation rules provided some taxpayers with a double tax benefit. (See present law and background discussion in F., below.) They point out that the foreign loss allocation rules proposed by the Administration would preclude that double tax benefit.

Interaction of deferral and the per country limitation

Imposition of a per country limitation, as the Administration proposes, puts the deferral issue (discussed in Part II, A., above) in a different context. The current overall limitation sometimes creates an incentive for taxpayers to bring home dividends from low-tax countries, the availability of deferral notwithstanding. This happens because, as already discussed, taxpayers can use high foreign taxes from one country to offset U.S. tax on low-taxed income from another country. The combination of a new per country limitation and continuation of deferral would change tax planning considerations. The present incentive to bring home dividends from low-tax countries would disappear if Congress (1) retains deferral and (2) enacts a per country limitation. To minimize taxes, taxpayers would tend to bring home dividends from companies operating in high-tax countries before they would bring home dividends from companies operating in low-tax countries. This tendency would arise because the dividends from companies operating in low-tax countries would no longer be tax-free. To the extent that taxpayers

refrained from bringing earnings from low-tax countries home, a quantity of U.S.-owned capital could become frozen overseas, unavailable for use here.

Although taxpayers might resist bringing home dividends from low-tax countries, however, they presumably would not invest in low-tax countries unless they contemplated eventually bringing earnings home. Therefore, imposition of a per country limitation with the continuation of deferral would probably tend only to delay, not to prevent, repatriation. Also, taxpayers who need funds in the United States might be willing to pay the tax cost of repatriation sooner rather than later.

Separate limitation for passive income

The present law separate limitations generally apply to certain types of income that would otherwise be particularly susceptible to averaging abuses.

Absent a separate limitation for passive interest, for example, such interest often could easily be used as an averaging tool, for two reasons. First interest is easily generated from foreign sources: A U.S. taxpayer can generate foreign source passive interest by withdrawing funds from a U.S. bank and depositing them in a foreign bank, for example. Second, a U.S. taxpayer can secure a low rate of foreign tax on passive interest by making an interest-bearing investment in a foreign country that either unilaterally, or pursuant to an income tax treaty with the United States, imposes little or no tax on passive interest. Prior to the adoption of the separate limitation for passive interest in 1962, U.S. taxpayers with excess foreign tax credits had an incentive to move passive interest-generating investments offshore because they could then average the excess credits with the low foreign taxes imposed on the foreign interest to reduce or eliminate the U.S. tax on that interest and use up the excess credits.

Under present law, other types of passive income, which are not subject to separate limitations, often can be manipulated to obtain averaging benefits in a manner similar to the way interest could be manipulated under prior law. Extending the application of the separate limitation for interest to other types of passive income would reduce the possibility of obtaining such averaging benefits.

Some argue that a general separate limitation for passive income is a workable alternative to a per country limitation as a device for limiting the averaging of foreign income and taxes. Such a separate limitation arguably would have some advantages over a per country limitation. First, the present overall limitation could be retained. Thus, the administrative complexity of a per country limitation could be avoided. For example, income and deductions generally would have to be allocated between passive and active income "baskets" only, rather than among a potentially large number of separate country baskets. (The limited expansion of the separate limitation for interest proposed by the Administration would not have this advantage if, as proposed, it applies on a per country basis.) Second, a separate limitation for passive income arguably would target averaging abuses more precisely than a per country limitation would. Such a separate limitation would prevent the averaging only of the most manipulable type of foreign income

with other foreign income. A per country limitation, on the other hand, would, among other things, prevent the averaging of highly taxed and lightly taxed active income (such as manufacturing income) that happens to be earned in different countries. The averaging of highly taxed and lightly taxed active income arguably is of less concern than the averaging of manipulable passive income with other income because active income-generating assets cannot, at least in the short run, be readily moved from the United States to a foreign country (as passive income-generating assets can be) to take advantage of sheltering possibilities. At the same time, a per country limitation, unlike a separate limitation for passive income, would *not* prevent the averaging of manipulable types of income with other income earned *within* a single country.

On the other hand, a separate limitation for passive income arguably would have certain disadvantages. As a preliminary matter, passive income would have to be defined. Most would probably agree with the Treasury Department that certain types of income, such as dividends paid on widely held shares of stock, should be considered passive. In addition, any financial income that arises by virtue of the time value of money should probably be considered passive. However, other types of income, such as royalties, are arguably active in some cases and passive in others. Developing workable rules for distinguishing active royalties from passive royalties—the application of which would not require a detailed, case-by-case factual inquiry—might prove difficult. In this respect and others, the present law separate limitation rules for interest may provide no more than a starting point for developing separate limitation rules for passive income generally.

In addition, some of the arguments made against a per country limitation also may be made against a separate limitation for passive income. For example, a separate limitation for passive income arguably would weaken the competitive position of some U.S. companies operating abroad and discourage the payment of dividends by some foreign subsidiaries to their U.S. parents. To prevent taxpayers from circumventing such a separate limitation, tracing rules similar in principle to those proposed by the Administration to prevent avoidance of the per country limitation would be necessary. Such tracing rules, it can be argued, would place a considerable administrative burden on both taxpayers and the Internal Revenue Service. On the other hand, similar rules, enacted in the Tax Reform Act of 1984, are already in place for passive interest income.

Separate limitation for lightly taxed income

Another possible alternative to a per country limitation for limiting the averaging of foreign income and taxes is a separate limitation for income lightly taxed abroad. Like a separate limitation for passive income, such a separate limitation could be applied using the overall method. Thus, the administrative complexity of allocating income and deductions among a potentially large number of separate income baskets could be avoided. In addition, a separate limitation for lightly taxed income obviously would curtail the averaging of highly and lightly taxed foreign income more directly

than either a per country limitation or a separate limitation for passive income.

One way to administer a separate limitation for income lightly taxed abroad would be to classify certain countries as low-tax countries and subject all income earned in those countries to the separate limitation. A separate limitation for lightly taxed income administered in this fashion would avoid the classification problems likely to arise in connection with a separate limitation for passive income. However, administered in this manner, a separate limitation for lightly taxed income would allow the averaging with income lightly taxed abroad of any income highly taxed by countries treated as low-tax countries. Such highly taxed income is likely to arise under a country-by-country classification system because, in some countries (including the United States), the effective rates of tax on different industries and on different types of income vary widely.

Another potential problem with a country-by-country classification system would be what methodology to use to make the classifications of high-tax or low-tax status. If effective tax rates were used, then such rates presumably would have to be calculated from taxpayer return information. Since neither income-earning patterns of U.S. taxpayers nor tax rules in a particular foreign country remain static, redeterminations would be necessary from time to time. If instead foreign countries' tax rules as applied were used to make the classifications, then the Internal Revenue Service presumably would have to study the tax rules of each foreign country to which U.S. taxpayers pay income tax and weigh the deductions, credits, rebates etc. provided against the tax rates.

Another way to administer a separate limitation for lightly taxed income would be to classify income as lightly or highly taxed on an item-by-item basis. This, however, arguably would involve administrative complexities on par with those that would arise in administering a per item limitation. Placing on the taxpayer the burden of showing that a particular item of income should be outside the separate limitation for lightly taxed income would only shift the administrative burden from the Internal Revenue Service to the taxpayer and might permit a taxpayer to obtain averaging benefits simply by declining to offer evidence that a particular item of highly taxed income should be outside the separate limitation.

Another way to administer a separation limitation for lightly taxed income would be to classify income as lightly or highly taxed on a category-by-category basis. Some categories of income earned abroad by U.S. persons, such as interest, generally tend to be lightly taxed there, while others, such as income subject to net taxation by income tax treaty partners of the United States, generally tend to be relatively highly taxed. As indicated above, under present law, some categories of income that generally tend to be either lightly taxed or highly taxed overseas are subject to separate foreign tax credit limitations. A difficulty with a category-by-category approach, however, would be that many categories of income are not consistently highly or lightly taxed abroad. Classifying these types of income as highly or lightly taxed could result in significant averaging within a category of income, to the extent that for-

eign tax rates on that category of income vary significantly for a particular taxpayer.

Other arguments against a separate limitation for lightly taxed income are that, like a per country limitation, it would limit the averaging of highly and lightly taxed active income not generally susceptible to manipulation, weaken the competitive position of some U.S. companies operating abroad, and discourage dividend repatriation. To prevent taxpayers from circumventing such a separate limitation, tracing rules similar in principle to those proposed by the Administration to prevent avoidance of the per country limitation probably would be necessary. Such tracing rules arguably would add further complexity.

Excess limitation carryover

Substituting an excess limitation carryover for the present foreign tax credit carryback could simplify somewhat the administration of the foreign tax credit. Under present law, if a taxpayer with excess credits in the current year had excess limitation in either of the two preceding years, the taxpayer must carry the excess credits back to the preceding excess limitation year or years for utilization before carrying them forward to future excess limitation years within the carryover period. A carryback of credits necessitates the filing of an amended return by the taxpayer for the year to which the credits are carried, and the processing of that return by the Internal Revenue Service. Since the foreign tax credit must be claimed before other business credits (such as the investment tax credit), a carryback of foreign tax credits can necessitate the recomputation of other business credits originally claimed in the carryback year. The reopening of previous tax returns could be avoided if the tax law permitted excess limitation to be carried forward to years in which excess credits arise.

An excess limitation carryover also might lessen (in some cases) the disincentive to repatriate dividends that opponents of the Administration's per country limitation proposal argue a per country limitation would create. As indicated in the present law and background discussion of the foreign tax credit carryback and carryover above, differences between the United States' rules for reporting income and those of other countries sometimes result in income being reported to and taxed by a foreign country in a later year than the income is considered earned for U.S. tax purposes. Under present law, a U.S.-owned foreign subsidiary may repatriate such income in the year it is considered earned for U.S. foreign tax credit purposes—despite the fact that it has not yet been recognized and taxed by the subsidiary's country and thus carries no foreign tax credit—because the overall limitation permits the subsidiary's U.S. owner or owners to offset the U.S. tax on this repatriated income with excess foreign tax credits generated in connection with other income.

Under a per country limitation, by contrast, some argue that such income would not be repatriated in the year it is considered earned for U.S. foreign tax credit purposes because excess credits generated in connection with income earned in other countries would not be available to offset the U.S. tax on the income, and it might be difficult later to carry back foreign taxes paid subsequent-

ly on the income to offset that U.S. tax. If, however, the tax law permitted the excess limitation arising in the year the income is considered earned for U.S. foreign tax credit purposes to be carried forward to the year in which foreign tax is finally imposed on the income, that foreign tax could be wholly or partly credited in the later year. Therefore, the argument goes, the income might continue to be repatriated in the earlier year despite the shift to a per country limitation. (Some supporters of the Administration's per country limitation proposal suggest that the proposed treatment of dividends paid by a U.S.-owned foreign subsidiary as coming from the subsidiary's multi-year pool of profits rather than first from its current year profits (the present law rule for foreign tax credit purposes) (see E., below) would forestall to a substantial extent the foreign tax credit utilization problem just described.)

One way that an excess limitation carryover could work is as follows: The difference between the foreign tax credit limitation amount and the foreign taxes actually credited in an earlier year would be added to the foreign tax credit limitation amount in the current year to permit what would otherwise be excess credits in the current year to be utilized currently. A credit carryover would then be available only for excess credits remaining after the earlier year excess limitation had been carried forward and used up. A two-year excess limitation carryover designed in this manner would provide a roughly the same tax benefit as the present two-year credit carryback. A longer excess limitation carryover would allow taxpayers to utilize additional excess credits.

One drawback of an excess limitation carryover would be that it would benefit a taxpayer in a high-foreign-tax-year only if the taxpayer had sufficient U.S. income and, hence, sufficient pre-credit U.S. tax in that year to absorb prior year excess limitation. For example, assume that a taxpayer has no U.S. income and $10 of foreign income in Year 1 and pays no foreign tax in that year. Assuming a 46-percent rate of U.S. tax, the taxpayer pays $4.60 of U.S. tax and has $4.60 of excess limitation in Year 1. (Excess limitation is computed by subtracting foreign taxes paid from the foreign tax credit limitation: (($4.60 x $10/$10) − $0 = $4.60).) In Year 2, the taxpayer has no U.S. income and $20 of foreign income and pays $13 of foreign tax. Assuming again a 46-percent rate of U.S. tax, the taxpayer's pre-credit U.S. tax liability in Year 2 is $9.20. If carried to Year 2, the excess limitation of $4.60 in Year 1 would increase the taxpayer's foreign tax credit limitation in Year 2 from $9.20 ($9.20 x $20/$20) to $13.80. However, this expanded limitation would not allow the taxpayer to fully credit in Year 2 the $13 of foreign tax it paid in that year because its total pre-credit U.S. tax liability in Year 2 is only $9.20.

If the taxpayer also had, for example, $20 of U.S. income in Year 2, it *would* be able to credit fully the $13 of foreign tax paid in that year because its pre-credit U.S. tax liability in that case would be $18.40 ($40 x .46) and its foreign tax credit limitation after the limitation carryover would be $13.80 (($18.40 x $20/$40) + $4.60).

When the taxpayer in this example has no U.S. income in Year 2, the existing foreign tax credit carryback, unlike the excess limitation carryover, provides relief from excess foreign tax credits. The excess foreign tax credit of $3.80 in Year 2 ($13 − $9.20) can be

carried back to Year 1 to reduce the taxpayer's $4.60 of pre-credit U.S. tax liability in that year to 80 cents. This example suggests that it may be desirable to retain the foreign tax credit carryback as an option if an excess limitation carryover is adopted.

Extension of foreign tax credit carryover period

Those who favor the proposed extension of the foreign tax credit carryover period from five to 10 years point out that, under present law, some taxpayers are sometimes unable to use all of their excess foreign tax credits. Some proponents of the extension argue that, under the Administration reform plan, this excess credit problem could become worse because certain features of the Administration plan (most notably the proposed tax rate reductions and per country limitation) may interact to increase some taxpayers' excess credits.

Proponents of the extension point out that the carryback and carryover periods for net operating losses and investment tax credits have been liberalized several times over the last few decades, while the carryback and carryover periods for the foreign tax credit have not been changed since the carryback and carryover were first enacted in 1958. They note the recognition by Congress that net operating losses (by reducing pre-credit U.S. tax) may cause both investment tax credits and foreign tax credits to expire unused; they argue that the enactment of ACRS in 1981 potentially increased the magnitude of the problem since ACRS deductions may increase net operating losses. Congress, they argue, tried to forestall this result of ACRS in the case of the investment tax credit, by extending the investment tax credit carryover period to its present 15 years at the time ACRS was enacted.

Proponents further argue that the appropriate length for any carryover period (whether for net operating losses, investment tax credits, or foreign tax credits) cannot be determined with absolute precision. Therefore, in their view, a carryover period should be sufficiently lengthy to minimize the likelihood that the purpose of the tax attribute at issue (that is, net operating losses, investment tax credits, or foreign tax credits) will be frustrated by the expiration of that tax attribute.

On the other hand, the present two-year carryback, five-year carryover, it can be argued, helps preserves the matching principle arguably inherent in the foreign tax credit system: to prevent double taxation, a foreign tax credit is allowed for foreign taxes paid on certain income in order to offset pre-credit U.S. tax on that income. As discussed earlier, Congress enacted the foreign tax credit carryback and carryover because differences in the rules for reporting income in the United States and in other countries sometimes resulted in reporting the same income in one year in the United States and in another year in a foreign country. When income was reported in the United States in an earlier year than in a foreign country, the foreign taxes paid in the earlier year, and therefore the applicable foreign tax credit, tended to fall short of the foreign tax credit limitation. Thus, the foreign taxes did not fully offset U.S. tax on that income in the earlier year. Later, when the income was reported in the foreign country, the foreign taxes paid in the later year, and therefore the applicable foreign tax credit,

tended to exceed the foreign tax credit limitation. These foreign taxes could not be used to offset the earlier-imposed U.S. tax on the income. The present two-year carryback and five-year carryover arguably prevent the mismatching of income and credits and consequent double taxation that resulted from such timing differences in the reporting of income under U.S. law and foreign law.

A longer carryover (or carryback), on the other hand, might permit the foreign taxes paid on one year's income to offset pre-credit U.S. tax on another year's income (after timing differences in reporting income are accounted for), and thus contravert the matching principle. If the length of the present carryover period already, on occasion, gives rise to such mismatching, then extending the carryover period would, of course, enlarge the problem.

A longer carryover period may be appropriate for the investment tax credit and net operating losses because the purposes of the carryovers for these tax attributes differ significantly from the purpose of the carryover for the foreign tax credit. That is, the matching principle just described has no apparent relevance to the investment tax credit or net operating loss. The purpose of the investment tax credit carryover is to preserve the investment incentive that the investment tax credit was enacted to provide. The purpose of the foreign tax credit, by contrast, is not to create an incentive. The net operating loss carryover functions as a general averaging device to alleviate the harsh effects often resulting from the use of the one-year accounting period and helps preserve the incentive effect of accelerated depreciation. The net operating loss carryover also shields businesses during difficult economic times and reduces differences in the total tax liabilities, over a multi-year period, of taxpayers with equal incomes over the period, some of whom have net operating losses and some of whom do not during the period.

Opponents of the extension of the credit carryover period point out that two other features of the Administration proposal—the per country election to deduct or credit foreign taxes and the U.S. loss recapture rule—would aid taxpayers in utilizing additional excess foreign tax credits.

Per country election to deduct or credit foreign taxes

Excess foreign tax credits can arise for a variety of reasons. One reason is that foreign countries include in their tax bases more income than the United States would. "Base-broadening" by foreign countries can take various forms, such as the denial of deductions that U.S. law would allow. Another form of base-broadening arises when a foreign country taxes income that the United States considers U.S. income—when the two countries disagree about the source of income. The United States treats compensation for personal services performed in the United States as U.S. income, for example, while a number of countries impose gross withholding taxes on payments for technical services (such as engineering services, architectural services, and other construction contract services) that a U.S. taxpayer performs in the United States for use within their borders.

Some favoring the Administration proposal to allow taxpayers to elect to deduct or to credit foreign taxes on a country-by-country

basis argue that the proposed tax rate reductions and per country limitation would increase some taxpayer's excess foreign tax credits. They point out, for example, that a taxpayer with no foreign income in a particular country under U.S. source rules that is taxed by that country would be unable under a per country limitation to credit the taxes paid against U.S. tax on foreign income earned in other countries. If the election to deduct or to credit foreign taxes were available on a per country basis, this taxpayer could elect to deduct such foreign taxes without losing its ability to credit foreign taxes paid to other countries.

Those opposed to a per country election point out, however, that Congress requires taxpayers either to deduct or to credit all foreign taxes because allowing a deduction for foreign taxes not credited would reduce the U.S. tax rate on U.S. income, and, thus, violate a premise of the foreign tax credit. Allowing such a deduction would have this effect under a per country limitation, an overall limitation, or any combination of the two. (The present prohibition of elections was enacted in the same legislation (passed in 1932) that established a per country limitation and limited the foreign tax credit to the lesser of the overall and per country limitation amounts.) Opponents of a per country election argue that if both a credit and deduction were allowed, preferential treatment would sometimes be given to taxpayers receiving income from foreign sources.

For example, assume that a taxpayer has $100 of income from foreign country A, no income from foreign country B, and $200 of U.S. income under U.S. source rules, and has paid $46 of tax to country A and $50 of tax to country B. Assume further that a per country limitation and the current law election rule apply and the taxpayer elects to credit rather than deduct foreign taxes paid during the year. The per country foreign tax credit limitation for country A is 100/300ths of $138 (the pre-credit U.S. tax on $300, assuming a 46-percent tax rate) or $46. Thus, the taxpayer can fully credit the $46 of foreign tax paid to country A and thereby eliminate its pre-credit U.S. tax liability of $46 on its $100 of country A income. The $46 credit reduces the taxpayer's total U.S. tax on its $300 of worldwide income from $138 (46 percent of $300) to $92. This $92 of tax represents the full U.S. tax due on $200 of U.S. income at a 46-percent tax rate. The per country foreign tax credit limitation for country B is 0/300ths of $138 or zero. Therefore, under the present election rule, the $50 of tax paid to country B represents an excess foreign tax credit. If the taxpayer could elect to deduct this $50 from its $300 of taxable income, however, the taxpayer's total U.S. tax would be reduced to $69 (46% of $250, minus the $46 credit for the country A tax). Since, as just indicated, a 46-percent tax on the taxpayer's U.S. income of $200 is $92, permitting such a deduction would reduce the U.S. tax on the taxpayer's U.S. income.

Proponents of a per country election to credit or to deduct foreign taxes argue that the election often reduces U.S. tax on U.S. income in a case like that just given only because U.S. source rules define as U.S. income certain income that is treated as *non-U.S.* income by some foreign countries and taxed by those countries as income originating within their borders. Opponents of a per coun-

try election respond that the election could reduce U.S. tax on U.S. income in a case like that just given in the absence of any source rule conflict, for example, if country B has no net operating loss carryforward or does not provide a deduction provided under U.S. tax principles. In any event, opponents argue, if a source rule conflict is involved, a change in the United States' source rules, rather than in its credit election rules, should be considered—the former would appear to be the more direct solution to the problem. However, opponents of a per country election point out that the principal U.S. source rule at issue—the rule that compensation for personal services performed domestically is domestic income—is followed by most developed countries and is incorporated in the Model Double Tax Convention on Income and Capital of the Organization for Economic Cooperation and Development (OECD). They suggest that the U.S. tax base would be eroded were the United States either to cease treating as U.S. income certain income that other countries tax (for example, the construction contract services income described above), or to adopt a per country election. If either change were made, the U.S. Treasury arguably would absorb some of the burden of foreign taxes on U.S. income. Either change, it is argued further, could encourage foreign countries to enact further taxes or to increase existing taxes on income that the United States now treats as U.S. income.

Proponents of a per country election respond that such an election would not likely result in increased foreign taxes on U.S. income since many developing countries may not be able to increase their tax rates without discouraging investment by companies resident in foreign countries that do not provide a similar benefit. In addition, it has been pointed out, the tax laws of some industrialized countries (like Holland, Germany, Canada, and the United Kingdom) permit the deduction of taxes that lesser developed countries impose on income from construction contract services. Like the United States, these countries consider income from services to arise where the services are performed. However, these countries permit companies to credit foreign income taxes paid on foreign income, while deducting foreign income taxes paid on domestic income. Other countries (like Korea, and France and Switzerland by treaty) treat income from construction contract services used abroad but performed domestically as foreign source, and allow a credit for foreign taxes paid on that income. Because U.S. companies, by contrast, may be unable to credit the foreign taxes imposed on their income from construction contract services performed domestically, U.S. companies seeking to perform construction contract services domestically for foreigners arguably cannot easily compete with foreign companies doing so: U.S. companies may be able to provide construction contract services to foreigners only by operating through foreign subsidiaries. To the extent that U.S. businesses forego producing services at home for use in foreign countries, the United States loses jobs.

On the other hand, opponents of a per country election suggest that such an election could make U.S. tax law more favorable than the tax laws of the countries (United Kingdom, Holland) that allow deductions for foreign tax imposed on domestic income. Few, if any, of those countries allow taxpayers the choice of crediting such

taxes against domestic tax on foreign income. Permitting a deduction for foreign taxes imposed on domestic income, opponents argue further, is a more focused solution to the problem of foreign countries taxing U.S. income than a per country election would be, and is more favorable to taxpayers in certain cases, for example, where a foreign country taxes both U.S. and foreign income of a taxpayer in a particular year.

Those opposed to a per country election also argue that the Administration proposals to extend the foreign tax credit carryover period and to allow U.S. loss recapture (discussed in F., below) should alleviate excess credit pressures. Those proposals, it is asserted, like changes in certain U.S. source rules that conflict with some foreign countries' source rules, would generally be superior to a per country election as a means of reducing excess credits because they would not reduce U.S. tax on U.S. income.

C. Source Rules

Present Law and Background

As discussed in B., above, the foreign tax credit is limited to the amount of U.S. tax on foreign income. For the foreign tax credit mechanism to function, then, every item of income must have a source: that is, under the current overall limitation, it must arise either within the United States or without the United States. A source rule is important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States insists on imposing its full tax on U.S. income. If Congress adopts a per country limitation on the credit, every item of income must arise in one particular country.

In determining foreign taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-863 (and Treasury regulations promulgated thereunder) require taxpayers to allocate or apportion expenses between foreign income and U.S. income. A shift in the allocation of expenses from foreign to U.S. gross income increases foreign taxable income. This increase may reduce U.S. tax by increasing the amount of foreign tax that a taxpayer may credit.

Some of the current rules for determining the source of income and for allocating and apportioning deductions are summarized below.

Income derived from purchase and resale of property

Income derived from the purchase and resale of personal property, both tangible and intangible, is generally sourced at the location where the sale occurs. The place of sale is generally deemed to be the place where title to the property passes to the purchaser (the "title passage" rule).

Income derived from manufacture and sale of property

Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under Treasury regulations, half of such income generally is sourced in the country of manufacture, and half of the income is

sourced on the basis of the place of sale (determined under the title passage rule). The division of the income between manufacturing and selling activities may be made on the basis of an independent factory price rather than on a 50/50 basis, if such a price exists.

Income derived from intangible property

Royalty income derived from the license of intangible property generally is sourced in the country of use. For certain limited purposes, income derived from the sale of intangible property for an amount contingent on the use of the intangible is also sourced as if if were royalty income.

Dividend and interest income

Dividend and interest income generally is sourced in the country of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources (such a corporation is known as an "80/20 company"), dividends and interest paid by that corporation are treated as foreign income. Certain other exceptions to the source rules applicable to interest income are designed as tax exemptions for limited classes of income earned by foreign persons. For instance, interest on foreigners' U.S. bank accounts and deposits is exempt under current law. The current method of exempting this income is treating it as foreign source.

Transportation income

Under Treasury regulations, income or loss derived from providing transportation services generally is allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit to the territorial waters of the United States are treated as foreign expenses for purposes of this calculation. Under the Tax Reform Act of 1984, all transportation income attributable to transportation which begins and ends in the United States is treated as U.S. income. Transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or which begins in a U.S. possession and ends in the United States) generally is treated as 50-percent U.S. income and 50-percent foreign income.

Income derived from the lease or disposition of vessels and aircraft that are constructed in the United States and leased to U.S. persons is treated as U.S. income. Expenses, losses, and deductions incurred in leasing such vessels and aircraft are also attributable to U.S. income. These rules apply regardless of where the vessel or aircraft may be used.

Allocation and apportionment of expense

Treasury regulation sec. 1.861-8 sets forth detailed allocation and apportionment rules for certain types of deductions, including those for interest expense and research and development expenditures. Under the regulations, a taxpayer generally allocates and apportions interest expense between gross U.S. and gross foreign income on the basis of the value of the taxpayer's assets that generate gross U.S. and gross foreign income (Treas. Reg. sec. 1.861-8(e)(2)(v)). Optional gross income methods for allocating and appor-

tioning interest are also available (Treas. Reg. sec. 1.861-8(e)(2)(vi)). Under the regulations, interest expense incurred by a related group of corporations that files a consolidated tax return is required to be allocated between U.S. and foreign income on a separate company basis rather than on a consolidated group basis. This separate company allocation rule conflicts with a Court of Claims case, *International Telephone & Telegraph Corp.* v. *United States* (79-2 USTC para. 9649), decided under the law in effect prior to the effective date of the Treasury regulations. The *ITT* case indicates that expenses that are not definitely allocable against U.S. or foreign gross income should be deducted from gross income on a consolidated group basis.

The regulations generally allow tax-exempt income and assets generating tax-exempt income to be taken into account in allocating deductible interest expense. Financial institutions, which may deduct some interest used to carry tax-exempt assets, are the main beneficiaries of this rule.

Under a temporary statutory provision, taxpayers currently allocate all expenses for research and experimentation performed in the United States against U.S. income. That statutory provision suspends, until taxable years beginning on or after August 1, 1986, the rules under the regulations, which sometimes require allocation of some research and experimentation expenses against foreign income.

Taxpayers generally allocate expenses other than interest expenses on a company-by-company basis.

Administration Proposal

Income derived from purchase and sale of property

The title passage rule would be eliminated for income from the purchase and resale of inventory-type property. All income from the purchase and resale of inventory-type property would be sourced in the country of residence of the seller. An exception to this general rule would apply if the seller maintains a fixed place of business located outside of its country of residence and that fixed place of business participates materially in the sale generating the income. In such a case, the income would be sourced in the country where the fixed place of business is located. However, all sales to related foreign persons would be sourced in the seller's country of residence even if the seller maintains a fixed place of business in another country.

Income derived from manufacture and sale of property

Similar changes would be made in the rules for determining the source of income derived from the manufacture and sale of inventory-type products. The existing practice of sourcing a fixed percentage of such income on the basis of the place of manufacture would continue. However, the remaining portion of the income would be attributed to sales activity and would be sourced on the basis of the rules described in the preceding paragraph. The title passage rule would thus be eliminated.

The Administration does not propose a specific change in the 50/50 formula for allocating income from manufacturing and sales ac-

tivity to manufacturing and sales, respectively. However, it does indicate that a fixed percentage allocating a greater portion of income to manufacturing than to sales might be appropriate.

Income derived from the sale of other personal property

Income derived from sales of personal property used by the taxpayer in its business (including *Corn Products* type property that would otherwise be passive investment property)[7] would be sourced in the place where the property is used. Income derived from the sale of personal property not described above, including gains derived from the sale of passive investment property such as stock, securities and commodity futures contracts, would be sourced on the basis of the taxpayer's residence.

Income derived from intangible property

The place-of-use rules relating to royalty income derived from licenses of intangible property would be retained in their present form. The source rules relating to sales of intangible property would be modified to correspond to the rules relating to licenses.

Dividend and interest income

The exceptions to the general dividend and interest source rules for 80-20 corporations would be repealed. The proposal would continue the exemption for U.S. bank account and bank deposit interest that foreigners earn, but would make the exemption explicit, while treating the exempt income as U.S. income.

Transportation income

The rule treating income from the sale or lease of aircraft or vessels manufactured in the United States as U.S. income would be repealed. The Administration also proposes reassessment of the rules relating to the allocation of transportation income between U.S. and foreign sources, including more general application of the 50-percent rule currently applied to possessions-related transportation income.

Allocation and apportionment of interest expense

Interest expense incurred by a corporation joining in filing a consolidated return would be allocated on a consolidated group basis. The separate company allocation method would be retained for taxpayers not filing a consolidated return. Also, tax-exempt interest income and assets generating tax-exempt interest would not be taken into account for purposes of allocating interest expense.

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[7] Under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal definition of a capital asset under Code section 1221 is not considered a capital asset if the property is used by a taxpayer as an integral part of a trade or business.

Other Proposal

H.R. 1359 (Mr. Heftel and others) and S. 861 (Sen. Wallop and others)

These bills would make permanent the temporary rule that allocates all expenses for U.S.-performed research and experimentation against U.S. income.

Analysis

Sales of property

In theory, the source rules should reflect the location of the economic activity generating the income at issue or the place of utilization of the asset generating that income. They also should operate clearly without the necessity for burdensome factual determinations, and should limit erosion of the U.S. tax base. When the rules are used to determine a U.S. person's foreign tax credit limitation, they generally should not treat as foreign income any income that foreign countries should not tax or do not tax.

Defenders of the title passage rule of present law argue that the rule operates clearly, provides certainty, and frequently provides a result that is consistent with an economic activity-type test. They contend that the title passage rule has worked well for many years. The importance of this rule in maintaining international competitiveness, they argue, more than offsets any possible erosion of the U.S. tax base. They emphasize the increased tax burden on export income that would arise if Congress adopted the Administration proposal.

Opponents of the title passage rule argue that it allows taxpayers to treat as foreign sales income what should be U.S. sales income simply by passing title to the property sold offshore. They argue that foreign countries are unlikely to tax income on a title passage basis. Therefore, foreign treatment might allow the sales income to escape tax by virtue of foreign taxes wholly unrelated to the sales income. The result, it is argued, is erosion of the U.S. tax base. The Administration notes that some increase in taxes on export income may occur, but argues that export incentives should be targeted to all exporters, not just to exporters that have excess foreign tax credits that they can use to shelter export income that is frequently unrelated to the income that generated the credits. The Administration argues that replacing the title passage rule with rules requiring a fixed place of business in a country in order to source sales income in that country would more accurately take into account the underlying economic activity generating the income and reduce the opportunities for manipulation, without significantly increasing the difficulty of determining the source of income. The Uniform Commercial Code, now in force in most States, attaches little or no importance to the place of title passage.

Proponents of the title passage rule reply that the Administration proposal might encourage taxpayers seeking foreign source income to move sales activities to foreign countries. Conducting sales activities offshore not only removes economic activity from the United States, but it might also result in higher foreign taxes whose burden would fall on U.S. taxpayers or, through the foreign

tax credit, on the U.S. Government. They argue that the fixed place of business test would be difficult to apply in practice.

As indicated above, Treasury regulations presently allocate income earned from manufacturing and sales activity 50 percent to manufacturing and 50 percent to sales for source rule purposes. The Administration proposes that the 50-50 formula be reassessed. The 50-50 split generally may not reflect the relative importance of manufacturing and sales, respectively, in the generation of income. In 1981, for example, book net income as a percentage of business receipts was 3.1 percent for manufacturing and 1.7 percent for wholesale trade. While some manufacturers engage in wholesaling, and some wholesalers engage in manufacturing, this result suggests that more income should generally be treated as arising from the manufacturing function than from the sales function. However, book receipts for a given product sold by a wholesaler would tend to be greater than those for the same product when the manufacturer sold it. In addition, the economy-wide ratios of book income to receipts are averages that might not be accurate in particular cases.

In any event, it is impossible to develop any fixed formula that, in every factual situation, accurately reflects the respective amounts of income attributable to manufacturing and sales. One possible alternative to a fixed formula would be to require in each case involving the manufacture and sale of property that the allocation between manufacturing income and sales income be made on an arm's-length basis. This arm's-length determination would involve a great deal of administrative difficulty and uncertainty, however.

Whatever the appropriate rule for sales of property generally, a different rule might be appropriate when the United States bases its income inclusion on the recapture of previous deductions. In the case of recapture, the income recaptured should perhaps have the same source as the income the deductions offset.

Intangibles

The Administration would retain the present rules which source royalty income derived from licenses of intangible property in the country where the intangible property is used. It would change the source rules for sales of intangible property: the source of income from such sales would be the country where the property is to be used. Some argue that this proposal is inconsistent with the proposals for other property. In the case of development and sale of intangible property, it may be reasonable to apportion all or some part of the associated income to the place of development of the property. Similarly, the argument for sourcing a U.S. person's sales income in the United States unless the sale is made through a permanent establishment in another country arguably is as valid for intangible property as it is for tangible property. Absent a permanent establishment in another country, it is unlikely that any country would tax a U.S. person's sales of intangible property. In the absence of a foreign tax, there may be no compelling reason to treat income as foreign source, because foreign source treatment could allow it to escape tax by virtue of unrelated foreign taxes on other income. (A per country limitation would make imposition of

U.S. tax more likely.) The difficulty of distinguishing sales from licenses, however, could be one reason to treat income from sales and licenses in the same way (although taxpayers and the IRS must frequently make this distinction today). In addition, treating the residence of the seller as the source of the income might not be appropriate if the seller purchased the intangibles from a third party who created the intangibles in some other country.

The Administration argues that since many countries (including the United States) tax royalty payments made to foreigners for the domestic use of intangibles, royalty payments to U.S. persons for intangibles used abroad should be foreign source. If the payments are U.S. source, no foreign tax credit might be allowed for foreign taxes on those payments. Some argue, however, that foreign source treatment unnecessarily undermines the U.S. tax base. They argue that the current temporary rule allocating all expenses for U.S.-performed research against U.S. income militates in favor of U.S.-source treatment for the royalty income that U.S.-performed research produces. One possible alternative would be to source the income from the development and/or sale of intangible property using the same rules as for tangible property. The United States could allow a deduction for any taxes paid on the U.S.-source portion of the royalties. This approach, too, could involve difficult factual determinations, however. Here again, it is not clear that the treatment of purchased intangibles should correspond to the treatment of intangibles the taxpayer developed. Moreover, this approach could violate many U.S. tax treaty obligations.

Dividends and interest

The Administration argues that treating interest and dividends paid by 80-20 companies as U.S. income would limit the circumstances in which the United States cedes primary tax jurisdiction by treating income that is not ordinarily taxed by foreign countries as foreign income. Advocates of current law argue that these companies are foreign corporations except with respect to place of incorporation and therefore should be treated as foreign corporations. They argue that repeal of the 80-20 rule would result in some U.S. corporations moving offshore, which is not a result the United States should encourage. As for U.S. withholding taxes on payments to foreigners, they argue that U.S. corporations operating abroad normally borrow from local banks, and that to tax these borrowings would penalize U.S. business overseas. They argue that the Administration is overreaching in seeking to tax, for example, both interest payments by an 80-20 company, and interest payments by a U.S. branch of a foreign company (under its branch-level tax proposal, discussed below). In addition, they note that U.S. tax law looks through foreign corporations to "resource" their dividends and interest as U.S. income in limited cases. Opponents of the 80-20 rule respond that there should be some shareholder-level tax burden associated with U.S. incorporation, whatever a corporation's activities. As for treating payments from an 80-20 company as foreign for the purposes of the foreign tax credit limitation, they note that no foreign country is likely to tax these payments. They argue that the primary purpose of the 80-20 rules was to attract

foreign capital to U.S. corporations, not to allow U.S. taxpayers to shelter payments from U.S. corporations from tax.

As for interest that foreign investors earn on U.S. bank accounts and deposits, granting a specific exemption rather than foreign source treatment would ordinarily make no difference. That change would create collateral consequences, however: under the "resourcing" rule of Code section 904(g), U.S.-owned foreign corporations that deposit money in U.S. banks would then pay out dividends and interest attributable to the interest as U.S. income to U.S. taxpayers. This could cause these corporations to shift deposits to foreign banks. However, the current application of the resourcing rule might already have some slight tendency to cause U.S.-owned foreign corporations to invest overseas rather than in the United States, but Congress decided that U.S. taxpayers should not be able to convert the source of income by routing it through a foreign corporation.

Transportation income

The tentative Administration proposal to treat income and losses from transportation between the United States and foreign locations as half U.S. and half foreign source would allow taxpayers to deduct more of the losses that frequently now arise from transportation from U.S. income. In the case of profitable operations, the proposal would allow the United States to collect at least some tax on income that other countries are unlikely to tax fully, if at all. It is not clear why the United States allows foreign tax credits to offset U.S. tax on any income that a U.S. person earns outside a foreign country, since no foreign country would appear to have a greater right than the United States to tax that income. A 50-50 split for transportation income might make it more difficult in some cases, however, for U.S. companies to export or import goods. In addition, under current law, many foreign shipping companies pay no U.S. tax on income from transportation between the United States and foreign points because of one of two provisions: a country-by-country reciprocal exemption authorized by the Code, or a bilateral income tax treaty. Unless Congress explicitly required these foreign shipping companies to pay tax, the burden of a 50-50 split would fall almost entirely on U.S. taxpayers rather than their foreign competitors. When combined with the proposed per-country limitation, however, a 50–50 split would have a relatively less important impact on U.S. taxpayers than under an overall limitation.

The Administration proposal to treat income and losses from leasing U.S.-made vessels and aircraft for use outside the United States as foreign source would conform the treatment of that income to the general rules. It would reverse, however, a previous policy decision by Congress to permit the allocation of losses from depreciation deductions against U.S. income and thereby encourage financial institutions to buy and lease U.S.-made equipment.

Allocation of interest and other expenses

Advocates of a consolidated group allocation rule for interest argue that borrowing by one member of a corporate group rather than another should not affect how the group's interest expense is allocated between U.S. and foreign gross income. They assert that

money is fungible and, therefore, borrowing for one purpose by one member of a corporate group frees money generated within the group for the use of other members who might otherwise have had to borrow.[8]

Advocates of a consolidated group allocation rule also suggest that the separate company allocation rule of present law lets taxpayers arrange to have interest expense reduce U.S. income, even though that interest expense funds foreign activities, the income from which is sheltered from U.S. tax by the foreign tax credit. Thus, not only is no U.S. tax paid on the investment, the investment generates a U.S. tax loss. That is, present law allows corporations within a consolidated group to reduce U.S. tax by choosing which corporation will borrow money. The following example illustrates what might happen in the normal case, absent tax planning that would put the expense in a corporation without foreign assets.

Example 1

Assume that a U.S. corporation has $100 of U.S. assets[9] and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurs $20 of interest expense. Its net income is $20 ($40-$20). The interest expense reduces gross U.S. income and gross foreign income equally, resulting in $10 of each.

Under the present Treasury regulations, however, if all the taxpayer's assets generate gross U.S. income, then all the taxpayer's interest expense reduces gross U.S. income. To avoid having interest expense reduce foreign income, taxpayers can isolate interest expense in a corporation whose assets produce only U.S. income. This rule arguably creates opportunities for tax avoidance. Proponents of a consolidated group allocation rule point out that a U.S. corporation may arrange (1) to incur all the interest expense of its consolidated group, and (2) to have all its assets generate gross U.S. income.

Example 2

The facts are the same as Example 1, above, except that the U.S. corporation borrows cash and contributes the cash to the capital of a U.S. holding company (the sole asset of the U.S. parent). Half of the assets of this U.S. holding company are foreign, and half of its assets are U.S. This U.S. holding company has $100 of U.S. assets and $100 of foreign assets, $20 of gross U.S. income and $20 of gross foreign income. It incurs no interest expense. It pays all its $40 of earnings to the parent as a dividend. Under the 100-percent dividends received deduction, the parent has no income from this dividend. The parent has no gross income (after the dividends received deduction), but it has $20 of interest expense. This $20 reduces only U.S. income.[10] Therefore, the group has $20 of foreign income (the

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[8] Although the United States has chosen the fungibility approach generally, the existing rules, whether or not extended to a group basis, may need improvements. Mechanical application of a fungibility rule can yield unintended results, particularly if foreign taxes are assigned to gross income on a pro rata basis like expenses.

[9] For simplicity, use of the asset method for allocating and apportioning interest is assumed in Examples 1 through 6.

[10] The holding company is a U.S. asset in the hands of the parent under present law so long as less than 80 percent of its gross income is foreign.

interest expense now will not reduce foreign income) and $0 (zero) of U.S. income. If foreign tax credits shelter all the foreign income, the U.S. corporation can eliminate its U.S. tax.

The potential for abuse is especially clear in the case of a debt-financed acquisition, where the acquirer can isolate interest expense used to buy U.S. and foreign assets in a corporation with only U.S. gross income.[11] The following example illustrates this point.

Example 3

U.S. corporation 1 has $100 of U.S. assets and $10 of U.S. income. U.S. corporation 2 has $50 of U.S. assets and $50 of foreign assets. It has $5 of U.S. income and $5 of foreign income. Neither company has any interest expense. Corporation 1 borrows $100 to buy Corporation 2 and incurs $8 of interest expense. The consolidated return filed by corporations 1 and 2 shows $7 (10 + 5 − 8) of U.S. income and $5 of foreign income. Thus, despite the fact that the interest expense was incurred in part to acquire foreign income, all of the interest expense is allocated to U.S. sources.

Advocates of a consolidated group allocation rule also argue that the conflict (described above) between the *ITT* case and the Treasury regulations governing interest allocation may allow some taxpayers to choose the allocation method (consolidated group or separate company) that produces the least U.S. tax.

Example 4

U.S. corporation 1 owns $100 of U.S. business assets and U.S. corporation 2 owns $100 of assets that it uses in a foreign business. These corporations file a consolidated return. U.S. corporation 2 incurs $20 of interest expense, while corporation 1 incurs no interest expense. Under the regulations, this $20 would reduce only foreign gross income. Under the theory of the *ITT* case, this $20 would reduce U.S. gross income and foreign gross income equally.

Opponents of a consolidated group allocation rule argue, however, that applying a fungibility concept to allocation of interest expense would be inappropriate in many cases in a consolidated group setting. For example, funds borrowed by one group member, it is argued, often do not benefit an affiliate carrying on unrelated operations or an affiliate operating in another country or region of the world. They indicate that interest expense is traced for allocation purposes to the income it helps generate by nearly all U.S. trading partners and is also traced for certain purposes under the Code. Proponents of a consolidated group allocation rule respond that tracing is often extremely difficult and is presently available in U.S. tax law only in limited circumstances. They argue that lenders generally make loans on the basis of all a group's assets, wherever situated.

Opponents of a consolidated group allocation rule point out that the interest expense deduction of a foreign corporation doing business in the United States is determined on a separate company rather than consolidated group basis (under Treas. Reg. sec. 1.882-

[11] *See, e.g.*, Joint Committee on Taxation, *Federal Income Tax Aspect of Hostile Takeovers and Other Corporate Mergers and Acquisitions* (JCS-9-85), April 19, 1985, p. 53.

5). (A discussion of the expense rules governing foreign corporations appears in Part VI, below.) Proponents of a consolidated group allocation rule respond that there is no inherent reason to require expense allocation rules for U.S. taxpayers operating abroad to mirror expense allocation rules for foreign taxpayers operating in the United States. The interest expense allocation rule for foreign corporations operates on a separate company basis, they suggest, primarily because administration of a consolidated group rule would require the Internal Revenue Service on audit to obtain the books and records of all foreign companies affiliated with a foreign corporation doing business in the United States. There would be significant practical and jurisdictional barriers to obtaining such books and records. It might not be reasonable for the United States to require this information from foreign taxpayers, especially since the United States taxes only certain income of foreign taxpayers. Similar barriers, by contrast, arguably would not exist to obtaining the books and records of U.S. affiliates of a U.S. corporation for purposes of applying a consolidated group allocation rule to such a corporation.

Opponents of a consolidated group allocation rule also argue, however, that it would significantly impair the ability of U.S. companies and their subsidiaries to compete abroad because it would sometimes result in greater allocation of interest expense to foreign income and a reduced foreign tax credit limitation and, thus, higher post-credit U.S. taxes. Advocates of such a rule, on the other hand, reiterate that the present law separate company allocation rule permits erosion of the U.S. tax base because it allows some taxpayers to reduce U.S. taxable income with interest expense that helps generate foreign rather than U.S. income.

Finally, opponents of the consolidated group allocation rule proposed by the Administration argue that that rule would be unfair because it would fail to take into account interest expense incurred by *foreign* affiliates: under a fungibility theory, they argue, foreign-borne interest may help generate *U.S.* income of the group and, thus, should be available for allocation against U.S. income. In any event, they argue that failure to take into account interest expense of foreign affiliates does not recognize the possibility that a foreign affiliate may bear an appropriate amount of interest expense before any allocation of interest paid by U.S. affiliates.

Example 5

A U.S. parent company operates directly a U.S. business and owns a foreign operating subsidiary. The U.S. business and the foreign subsidiary each have $100 of assets. The foreign subsidiary earned $25 of net (pre-interest and pre-tax) income, but incurred $5 of interest expense. It distributes $20 to the parent as a dividend, and the parent has $20 of U.S. income (pre-interest allocation and pre-tax) from its U.S. business. The parent has no other foreign income. The parent incurs $15 of interest expense. Under present law and the Administration proposal, the $15 of interest expense is evenly divided between the parent's U.S. income and foreign income ($7.50 each). The parent, therefore, has $12.50 of taxable U.S. income, and $12.50 of taxable foreign income. Under the Administration proposal, the $5 of interest expense that the foreign

subsidiary incurs does not directly reduce the U.S. taxable income of the U.S. parent. That $5 indirectly reduces U.S. taxable income by reducing the dividend the foreign corporation can pay.

A different result would occur in Example 5 if the interest expense allocation rules took foreign borrowings into account. Taxpayers could allocate against U.S. income the lesser of two amounts: (1) worldwide interest expenses of the affiliated group multiplied by a fraction, U.S. assets divided by worldwide assets, or (2) interest expense incurred by U.S. taxpayers. (In computing worldwide assets for this purpose, foreign assets could include assets purchased with indebtedness that foreign affiliates owe.)

Example 6

The facts are the same in Example 5, above. The interest expense allocated against U.S. income is $10. This is the lesser of $10 (worldwide interest expense ($20) multiplied by U.S. assets divided by worldwide assets ($100/$200)) or $15 (interest expense incurred by the U.S. taxpayer). The parent has $10 of taxable U.S. income, and $15 of taxable foreign income. The $5 of interest expense that the foreign subsidiary incurs does not reduce U.S. tax, but it enters into the allocation calculation.

If it is appropriate to bring in foreign borrowings of affiliates, some adjustment to the method of allocating expense on account of foreign subsidiaries would probably be appropriate. (Such an adjustment might be appropriate even if foreign borrowings are not brought in.) Under current law, taxpayers using the asset method generally treat their basis in the foreign subsidiary's stock as the amount to which they allocate expense. This stock basis amount does not reflect retained earnings of the foreign subsidiary, or any other appreciation in value of the shares owned by the U.S. taxpayer. Taxpayers using the gross income method allocate expenses against only the net dividend they receive from a foreign subsidiary, not against the gross income that generated the net income that gave rise to the dividend. (These dividends are already net of foreign-borne interest expense.) These rules tend to understate the allocation against foreign income and thus to overstate the allocation against U.S. income. These rules thus tend, perhaps inappropriately, to increase the foreign taxes that U.S. taxpayers can credit.

The Administration proposal would consider only members of a consolidated group, and not unconsolidated domestic affiliates. Some taxpayers might be willing to forego any benefits they obtain from consolidation (primarily the netting of income and losses within the group) for the benefit of the favorable interest allocation they could obtain by deconsolidating. To address this problem, Congress could limit the foreign income of U.S. members of an affiliated group that is not a consolidated group to the amount those members would have earned had they been members of a consolidated group, or Congress could prohibit deconsolidation.

An entirely different set of interest allocation rules applies to foreign taxpayers doing business in the United States. A discussion of those rules appears in Part VI, below. As suggested in Part VI, it might be appropriate for U.S. taxpayers and foreign taxpayers to use one method to allocate interest expense.

If a consolidated group approach is appropriate for interest expense, it may be appropriate for other expenses such as general and administrative expenses.

Proponents of the current rule treating tax-exempt obligations like any other U.S. asset for the purpose of apportioning interest expense argue that this rule reflects the true economic nature of the transactions because interest paid to carry tax-exempt bonds relates to U.S. assets. They also argue that this rule is consistent with the policy of permitting the deduction of the interest which is to encourage banks to hold tax-exempt State and municipal obligations. Removing these obligations from the allocation would be inconsistent with this policy.

Opponents of the current rule argue that banks should not trace interest deductions to tax-exempt income in determining the source of income. They argue that it is inappropriate to derive a second tax benefit (higher foreign income) from ownership of a tax-exempt asset.

Research expenses

Advocates of a permanent rule allocating all expenses for U.S.-performed research against only U.S. income argue that this rule would preserve research activity in the United States. They argue that the United States should especially encourage domestic research activity. They argue further that companies would move U.S. research offshore to obtain full deductions for research expenses. Opponents of a permanent full allocation against U.S. income argue that tax factors are relatively unimportant in the decision where to locate research facilities.

Advocates of a permanent 100-percent allocation against U.S. income argue that it is too difficult to link research expenses with any particular income, and that an automatic rule is appropriate. Opponents of a 100-percent allocation agree that linking research expenses with income is difficult, but they contend that a formula splitting research expense between U.S. and foreign income is more likely to approximate reality than is full allocation against U.S. income. Advocates of a 100-percent allocation reply that the formula in suspended Treasury Regulation 1.861-8 was too complex, and that it is difficult to conceive of a formula that both seems fair in a broad range of cases and is simple to apply.

Opponents of a 100-percent allocation against U.S. income argue that U.S.-performed research frequently results in foreign income. They argue that it is unfair for some taxpayers to overstate foreign income that they can shelter with foreign tax credits. They note that a 100-percent allocation helps only taxpayers with excess foreign tax credits, and not other taxpayers that perform research in the United States. They argue that a Treasury study indicates that the bulk of the tax benefits of a 100-percent allocation goes to a small number of mature multinationals and that very little of the benefits go to small high-technology companies. Advocates of a 100-percent allocation reply that mature multinationals perform a great deal of the research that is performed in this country, and that the tax law should treat all taxpayers, including mature multinationals, fairly.

D. Creditability of Foreign Taxes

Present Law and Background

The foreign tax credit is available only for income, war profits, and excess profits taxes paid to a foreign country or a U.S. possession and for certain taxes imposed in lieu of them (Code secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of how the levy is denominated by the foreign government that imposes it.[12] To be considered an income tax, a foreign levy must be directed at the taxpayer's net gain.[13]

Treasury regulations provide detailed rules for determining whether a foreign levy is creditable (Treas. Reg. secs. 1.901-1 through 1.901-4 and 1.903-1). In general, under the regulations, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. The predominant character of a levy is that of an income tax in the U.S. sense if the levy is likely to reach net gain in the normal circumstances in which it applies and the levy is not dependent on the availability of a foreign tax credit in another country (a levy that is so dependent is referred to as a "soak-up" tax).

A foreign levy is a creditable tax "in lieu of" an income tax under the regulations only if the levy is a tax and is a substitute for, rather than an addition to, a generally imposed income tax. A foreign levy may satisfy the substitution requirement only to the extent that it is not a soak-up tax.

An earlier version of the regulation governing "in lieu of" taxes (Temp. Treas. Reg. sec. 4.903-1, T.D. 7739, filed November 12, 1980) required, in addition, that a foreign levy be comparable in amount to the amount that would have been paid on the income involved had the general income tax of the levying country (or U.S. possession) applied to that income. The Treasury Department omitted the comparability rule from the final regulations after concluding that the statutory language of section 903 probably did not grant the Internal Revenue Service ample authority to promulgate such a rule. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") added a similarly worded comparability requirement to the Code's special foreign tax credit rules for foreign oil and gas income (sec. 907(b)). Under the TEFRA comparability rule for foreign oil and gas income, unlike the temporary section 903 comparability rule, an otherwise creditable foreign tax is creditable to the extent of the amount of the general income tax that would otherwise be imposed, notwithstanding an absence of comparability, that is, in a case where the total amount of the tax paid is materially greater

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[12] *Biddle* v. *Commissioner*, 302 U.S. 573 (1938).
[13] *Bank of America National T. & S. Association* v. *United States*, 459 F.2d 513 (Ct. Cl. 1972).

than the amount of the general income tax that would otherwise be imposed.

The regulations allow a credit only for that amount of an income tax or "in lieu of" tax that is paid to a foreign country by the taxpayer. A tax is not "paid" to a foreign country if it is used directly or indirectly as a subsidy to the taxpayer or is reasonably certain to be refunded, credited, rebated, abated, or forgiven. The "taxpayer" is the person upon whom foreign law imposes legal liability for a tax. However, a tax is considered paid by the taxpayer even if another party to a transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's liability for the tax.

The current regulations generally test the creditability of gross withholding taxes on interest under the "in lieu of" rules of section 903 rather than under the creditability rules of section 901. Such withholding taxes generally were tested for creditability under section 901 under prior law.

Foreign borrowers frequently pay interest on loans from U.S. lenders "net" of foreign income taxes. That is, the borrowers promise the lenders a certain after-foreign tax interest rate on the loans and agree to assume the lenders' liability for any foreign income taxes imposed. In general, under the regulations, foreign taxes paid by foreign borrowers pursuant to such arrangements are creditable in full by the U.S. lenders: the taxes are considered paid by the lenders notwithstanding that the foreign borrowers agree to pay them and most foreign countries do not refund or otherwise forgive the taxes so they are considered "paid" to the countries. However, in certain cases where the foreign borrower is a foreign government or is owned by a foreign government, present law is somewhat unclear regarding whether foreign taxes paid by the borrower are creditable in full by the U.S. lender.

A U.S. lender can use the foreign tax credits granted for gross withholding taxes on interest or other taxes, liability for which is assumed by a foreign borrower, to reduce or eliminate the lender's U.S. tax liability with respect to the proceeds of loans to that borrower. In addition, under the overall foreign tax credit limitation, any excess foreign tax credits in connection with the loans may be used to reduce the lender's U.S. tax liability on other income it earns from the same foreign country or from other sources outside the United States. The separate foreign tax credit limitation for interest may not limit this use of excess credits in many cases because it does not apply to interest income derived in the conduct of a banking, financing, or similar business.

Some foreign countries' gross withholding taxes on interest exceed the general net income taxes that would otherwise be imposed by the foreign countries on interest income.

Administration Proposal

No specific proposal. However, the proposed substitution of a per country foreign tax credit limitation for the overall foreign tax credit limitation would prevent U.S. lenders (and other U.S. taxpayers) from using excess foreign tax credits from one foreign country to reduce their U.S. tax liability on income earned from other sources outside the United States.

Other Possible Proposals

1. Require, for any portion of a foreign levy to be creditable as an "in lieu of" tax, that the foreign levy be comparable in amount to the amount that would have been paid on the income involved had the general income tax of the levying country (or U.S. possession) applied to that income. That is, codify the comparability requirement found in the 1980 version of the section 903 regulations.
2. Treat a foreign levy as a creditable "in lieu of" tax only to the extent of the amount of the general income tax of the levying country that would otherwise be imposed.
3. Establish a separate foreign tax credit limitation for income subject to "in lieu of" taxes.

Analysis

Those favoring a comparability requirement for "in lieu of" taxes argue that a foreign levy should not be creditable as a tax "in lieu of" an income tax unless it is comparable in amount to the general income tax that would otherwise be imposed by the levying country. They assert that the absence of a comparability requirement permits the full crediting of foreign taxes the predominant character of which is not that of income taxes in the U.S. sense.

Proponents of a comparability requirement note further that, among the foreign levies generally creditable by U.S. taxpayers as "in lieu of" taxes under present law, are gross withholding taxes on interest the formal liability for which frequently is assumed by the foreign borrowers paying the interest. When such an assumption of foreign tax liability occurs, the U.S. lender, it is argued, sometimes bears little or none of the economic burden of the foreign tax on the loan proceeds. In addition, if the foreign tax is high enough, the lender pays no U.S. tax on the loan proceeds under the United States' generally applicable foreign tax credit rules. Further, the U.S. lender may be subject to what is arguably a negative rate of U.S. tax on the foreign loan transaction under the overall foreign tax credit limitation (as other U.S. taxpayers operating abroad sometimes are on other foreign transactions). This may occur when the foreign withholding tax on the interest paid exceeds the pre-credit U.S. tax on the associated loan proceeds, and the lender uses the excess foreign tax credits to reduce its U.S. tax liability on other income, derived from the same foreign country or from other sources outside the United States, that is subject to little or no foreign tax. Proceeds from domestic loans, by contrast, generally bear some U.S. tax. Thus, the present foreign tax credit arguably provides an incentive for some U.S. lenders to make foreign loans rather than domestic loans. The higher the applicable foreign withholding tax on interest is, the larger the U.S. lender's foreign tax credit will be and, thus, the greater that incentive arguably may be. This means that foreign countries seeking to attract U.S. capital may have an incentive in some cases to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. According to a January 1985 report in the *Wall Street Journal*, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to *exempt* from a Mexican withholding tax on interest the interest payments made by a Mexi-

can state-owned food distributor to foreign banks.[14] (Staff understands that the Mexican Government subsequently withdrew the exemption.)

Opponents of a comparability requirement for "in lieu of" taxes argue that many countries' gross withholding taxes on interest would satisfy such a requirement and, therefore, imposition of such a requirement would not significantly limit the tax benefits just described. In addition, they say, a comparability rule for "in lieu of" taxes would be difficult to apply. For example, in the case of a gross withholding tax, gross and net tax burdens would have to be compared. If Congress nonetheless decided to adopt a comparability rule, opponents argue that it should be modeled after the comparability rule of section 907(b); that is, an absence of comparability should result in the loss of credit only for the amount of tax in excess of the amount of the income tax that would otherwise generally be imposed. As discussed in more detail below, opponents of a comparability rule also point out that U.S. lenders are not the only U.S. taxpayers with the ability to obtain what is arguably a negative U.S. tax rate on income earned in a particular foreign country. The overall limitation makes this possible generally for taxpayers with excess foreign tax credits and, therefore, it is argued, any reduction in the foreign tax benefits just described should only be considered in the broader context of a reexamination of the overall limitation.

Treating a foreign levy on interest paid to a U.S. lender as noncreditable to the extent that liability for the levy is formally assumed by a person other than the lender arguably may be another possible means of limiting the tax benefits described above. Those favoring such an approach argue that, under it, a U.S. lender would pay either full U.S. tax on a foreign loan (if the foreign levy in connection with the loan were found noncreditable) or would bear more of the economic burden of the foreign tax on the loan (if, to avoid a finding of noncreditability, the lender decided not to shift formal liability for the foreign tax to the borrower). In either case, it is argued, there would be a reduction in any incentive that U.S. lenders may have under present law in some cases to lend to foreigners rather than to U.S. persons.

Opponents of this approach disagree that it would reduce any incentive that U.S. lenders now have to lend to foreigners. They point out that a finding of noncreditability would *not* result in full U.S. tax on a foreign loan in a case where the foreign lender has excess foreign tax credits from other operations—such credits could be used to reduce the U.S. tax on the loan. More importantly, they argue, if this approach were taken, U.S. lenders would quickly respond by (1) ceasing to shift to foreign borrowers formal liability for foreign levies on foreign loans and (2) charging a higher interest rate on such loans. The present law after-tax return of U.S. lenders on foreign loans would thereby be preserved or nearly preserved, it is argued, and, thus, any incentive to make such loans instead of U.S. loans would remain intact.

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[14] S. K. Witcher, "Foreign Banks Worry Mexican Ruling Could Mean Loss of Tax Credits at Home," *Wall Street Journal*, Jan. 25, 1985, p. 24.

Opponents of the noncreditability rule under discussion emphasize that the increase in the interest rate that would be charged in the above case reflects a crucial fact: neither a formal arrangement under which a party other than the legal taxpayer assumes liability for a tax, nor the other terms of a transaction subject to a tax, necessarily determine where the economic burden of the tax falls. In light of this fact, it is contended, the disregard of such arrangements and terms under the present creditability rules is proper and should be continued.

Apropos the latter point, some assert that U.S. lenders lending overseas today bear a significant portion of the economic burden of foreign taxes the liability for which is assumed by the borrowers. For this reason, it is argued, such taxes should not be treated as noncreditable by the lenders. Proponents of a noncreditability rule, on the other hand, question the assertion that U.S. lenders bear a significant portion of the economic burden of such taxes, noting that major U.S. banks lending to Mexico, for example, reportedly protested recently when Mexico decided to exempt one Mexican borrower from a Mexican withholding tax on its interest payments to foreign banks.[15] Opponents of a noncreditability rule suggest in response that the protest by the banks does not prove that they failed to bear a portion of the Mexican withholding tax but rather that the exemption would have upset the preexisting economic arrangement between the banks and the borrower entirely to the banks' detriment. That is, the exemption arguably would have provided a windfall benefit to the borrower, who presumably was contractually liable for the withholding tax, while disadvantaging the lenders, who presumably would have lost the foreign tax credits they accrue when the withholding tax is imposed.

Some argue that the issue of U.S. lenders' foreign tax credits should be addressed, if at all, not by amending the creditability rules, but by amending the foreign tax credit limitation rules. U.S. lenders, as was noted above, are not the only U.S. taxpayers with the ability to obtain what is arguably a negative U.S. tax rate on income earned in a particular foreign country. Virtually any U.S. taxpayer operating in both high-tax and low-tax foreign countries can first eliminate any U.S. tax on income earned in the high-tax countries using the credits for the high foreign taxes imposed and then, under the overall foreign tax credit limitation, use the excess credits to reduce the U.S. tax on income earned in the low-tax countries. Only if Congress decides that all U.S. taxpayers should be denied this ability, it is argued, should U.S. lenders be denied this ability. The per country foreign tax credit limitation proposed by the Administration would accomplish this result.

Proponents of a change in the creditability rules, on the other hand, argue that U.S. loans to foreigners made "net" of foreign taxes present a special case because the U.S. lenders can in effect avoid *foreign* tax in addition to U.S. tax on such loans and, thus, they have an additional incentive to invest abroad that other U.S. taxpayers do not have. Opponents of such a change reiterate that U.S. lenders do not necessarily avoid foreign tax on such loans:

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[15] *See id.*

they may economically bear a portion of the foreign tax imposed by accepting a lower interest rate than they would have accepted if the loans had not been made "net" of foreign taxes.

An alternate change in the foreign tax credit limitation that would affect the U.S. lenders at issue would be the introduction of a separate limitation for income subject to "in lieu of" taxes. A separate limitation for "in lieu of" taxes would prevent U.S. lenders from using foreign tax credits for high gross withholding taxes to offset U.S. tax on other income subject to foreign net income taxes. However, such a separate limitation would not prevent U.S. lenders making loans in both high-tax and low-tax foreign countries that impose only gross withholding taxes on the loans from using the high gross withholding taxes imposed by the high-tax countries to offset the U.S. tax on the loan proceeds received from the low-tax countries. In these cases, what is arguably a negative rate of U.S. tax on the loan proceeds received from the high-tax countries would continue to apply. In addition, a separate limitation for income subject to "in lieu of" taxes could limit the foreign tax credits of some U.S. taxpayers other than U.S. lenders since a number of taxes other than gross withholding taxes may be "in lieu of" taxes.

A drawback in introducing either a separate limitation for income subject to "in lieu of" taxes or a per country limitation to reduce the incentive that arguably exists in some cases to make foreign loans is that, under either such a limitation, a U.S. lender making loans to parties in any particular high-tax foreign country "net" of foreign taxes and earning only highly taxed interest in such country arguably would continue to pay neither U.S. nor foreign tax on the loans. Changing the limitation would only prevent the lender from using the high foreign taxes to reduce U.S. tax on other income earned outside the United States.

E. Deemed-Paid Credit

Present Law and Background

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation are treated as if they had paid a share of the foreign income taxes paid by the foreign corporation in the year in which that corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. This is called the "deemed paid" or "indirect" foreign tax credit.

Earnings and profits of a foreign corporation are generally not subject to U.S. tax as dividend income of a U.S. shareholder until repatriated through an actual dividend distribution. However, subpart F of the Code treats certain undistributed earnings and profits of a controlled foreign corporation as a current "deemed" dividend.

In the case of an actual dividend distribution, the share of foreign tax paid by the foreign corporation that is eligible for the indirect credit is related to the share of that corporation's "accumulated profits" that is repatriated as a dividend to the U.S. corporate shareholder. Foreign taxes paid for a particular year are eligible

for the indirect credit only to the extent that there are accumulated profits for that year and then only in proportion to the share of such accumulated profits that is attributed to the dividend distribution. Distributions are considered made out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year are generally treated as paid out of the prior year's accumulated profits. The Internal Revenue Service has ruled that a foreign corporation's deficit in earnings and profits in any year reduces the most recently accumulated earnings and profits of prior years for purposes of matching prior years' foreign taxes with accumulated earnings and profits. Rev. Rul 74-550, 1974-2 C.B. 209.[15a]

In the case of a deemed dividend under subpart F of the Code, foreign taxes paid by the foreign corporation for the taxable year are eligible for the indirect credit only in proportion to the share of the controlled foreign corporation's "earnings and profits" of the year that is attributed to the deemed dividend.

That deemed paid credit is also available with respect to a sale of stock or corporate liquidation that produces dividend income under section 1248 of the Code. The dividend is considered an actual distribution and there are special rules for computing the earnings and profits to which the dividend is attributed.

For either an actual distribution or a subpart F inclusion, the amount of foreign tax eligible for the indirect credit is computed as a fraction of the foreign tax paid by the foreign corporation. The numerator of the fraction is the U.S. corporate shareholder's actual dividend or subpart F deemed dividend income from the foreign corporation. The denominator is the foreign after-tax "accumulated profits" (in the case of an actual dividend) or "earnings and profits" (in the case of a subpart F deemed dividend) attributed to the taxable year of the foreign tax. (The amount of foreign tax thus eligible for the indirect credit is also "grossed-up" and included in the U.S. corporate shareholder's income to treat the shareholder as if it had received it proportionate share of pre-tax profits and paid its proportionate share of foreign tax).[16]

Under this formula for computing the indirect credit, for any given dividend amount in the numerator of the fraction, a greater amount of accumulated profits (or earnings and profits) in the denominator of the fraction produces a smaller amount of foreign taxes allowed as a credit.

Both "accumulated profits" of a foreign corporation in the case of actual dividend distributions,[17] and "earnings and profits" of

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[15a] *Compare Champion International Corp.*, 81T.C. 424, 442 (1983); *Pacific Gamble Robinson Co.* v. *U.S.*, 62-1 USTC ¶ 9160 (W.D. Wash. 1961).

[16] For example, assume a foreign subsidiary earns $100 of income on which it pays $30 of foreign income tax. If a $35 dividend were paid (or deemed paid under subpart F) out of the $70 of after-tax earnings, the U.S. shareholder would have a $15 indirect foreign tax credit (35/70 x $30) and $50 of income ($35 + $15). The "gross-up" prevents the U.S. corporate taxpayer from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of the actual distribution or subpart F inclusion reflects only after-foreign tax profits. Such a deduction is advantageous when the foreign tax rate is lower then the U.S. rate.

[17] *Steel Improvement & Forge Co.*, 36 T.C. 265 (1961); rev'd on another issue 314 F. 2d 96 (6th Cir. 1963); Rev. Rul. 63-6, 1963-1 C.B. 126; Treas. Reg. § 1.902-1(e); *see H.H. Robertson Co.*, 59 T.C. 56 (1972), aff'd in unpublished opinion (3d Cir., July 24, 1974).

the foreign corporation, in the case of a subpart F deemed dividend (sec. 964(a)), are generally calculated in accordance with the principles governing the calculation of earnings and profits for U.S. tax purposes.

However, "accumulated profits" as calculated for purposes of the indirect credit with respect to actual distributions and "earnings and profits" as calculated for purposes of the indirect credit with respect to subpart F inclusions may differ in several respects. For example, the subpart F deemed dividend rules (which Treasury regulations allow a U.S. corporate shareholder to elect to apply to actual distributions from a controlled foreign corporation) do not require adjustment to U.S. financial and tax accounting principles if the adjustment is not "material." Different foreign currency translation rules for actual and for subpart F deemed distributions are mandatory.

In the case of an actual dividend distribution, the first-tier foreign corporation making the distribution is generally deemed to have paid a proportionate share of the foreign taxes paid by a second-tier foreign corporation of which it owns at least 10 percent of the voting stock, and the same principle applies between a second and a third-tier foreign corporation. However, even if the 10-percent test is met at each level, the deemed-paid credit will not be available for foreign taxes paid by a second or third-tier foreign corporation unless the product of the percentage ownership at each level equals at least 5 percent. Foreign taxes paid below the third-tier are not eligible for the deemed paid credit.

Similar rules apply to foreign taxes paid by first -and second-tier foreign corporations in the case of a subpart F deemed dividend to a U.S. company.

The Internal Revenue Service has ruled that the indirect credit is not available with respect to undistributed foreign personal holding company income includable as a dividend (sec. 551) in the income of a U.S. shareholder. Rev. Rul. 74-59, 1974-1 C.B. 183.

Foreign taxes eligible for the indirect credit, together with directly paid foreign taxes, are subject to the overall limitation that forbids a taxpayer to credit a greater amount of foreign tax than the U.S. tax otherwise imposed on foreign source income and to the "separate basket" calculation of the limitation for certain types of income. Dividends received are generally characterized as from foreign or domestic sources on the basis of the place of incorporation and other tax attributes of the corporation paying the dividend. Existing law also contains rules preventing the conversion of U.S. income into foreign income and interest income into non-interest income by routing that income through foreign affiliates.

For purposes of the excess credit carryback and carryover provisions, foreign taxes eligible for the indirect credit are deemed paid in the year the U.S. corporation includes the related dividend in income, regardless of when the taxes were paid to the foreign country.

Administration Proposal

For purposes of computing the indirect foreign tax credit, dividends would be considered made from the pool of all the distribut-

ing corporation's accumulated profits (in the case of actual distributions) or earnings and profits (in the case of subpart F deemed dividends). Earnings of the current year would be included in the relevant pool. The rule treating actual distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits would be repealed. A dividend (actual or subpart F) would be considered to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.

"Accumulated profits" for actual distributions would be required to be calculated in the same manner as "earnings and profits." In general, the earnings and profits and accumulated profits computations would be required to be made under rules similar to those now required for subpart F deemed dividends (and permitted for actual distributions). However, the rules for translating foreign currency would be modified.[18]

The pooling proposal would apply prospectively only. Future dividends would be treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that accumulated pool of post-effective date earnings would be treated as paid out of pre-effective date accumulated profits under the ordering principles of existing law.

Analysis

In general

In practice, the indirect foreign tax credit generally avoids multiple corporate level taxation and relieves international double taxation. In the U.S. domestic context, an individual shareholder generally receives dividends only net of tax paid at the corporate level; however, a corporate shareholder is allowed an 85 percent or 100 percent intercorporate dividend deduction, relieving multiple corporate level taxation. The fact that the indirect foreign tax credit is generally available only to corporate shareholders is consistent with this domestic regime.[19]

It has been said that one purpose of the indirect credit is to provide a U.S. parent corporation that is subject to U.S. tax on earnings of a foreign subsidiary with a foreign tax credit comparable to the credit that would have resulted had those earnings been taxed to the parent as a result of its operating in the foreign country directly through a branch.[20] As the paradigm case under this view, if

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[18] The indirect credit implications of the Administration proposals with respect to a per country foreign tax credit limitation and with respect to foreign currency exchange gains and losses are discussed in B., above, and V., below.

[19] Earnings of a foreign corporation, to the extent not effectively connected with a U.S. trade or business (or subject to certain other U.S. taxes on generally passive income) will not generally bear U.S. tax but may bear foreign tax. A dividend out of post-foreign tax earnings from a foreign corporation to a U.S. corporate shareholder will bear U.S. tax, against which the U.S. corporate shareholder can offset a portion of the foreign tax through the indirect foreign tax credit. In general, the result is a single corporate level tax at the higher of U.S. or foreign rates.

An individual U.S. shareholder who is taxed on an undistributed subpart F inclusion may elect to be taxed as if he or she were a domestic corporation and to receive the applicable deemed paid credit. A later, actual distribution is not eligible for the credit. In general the effect is to treat the shareholder with respect to the subpart F inclusion as if he or she had invested in a U.S. corporation doing business abroad.

[20] *See, e.g., Associated Telephone & Telegraph Co.* v. *United States*, 306 F. 2d 824, 832 (2d Cir. 1962), *cert. denied* 371 U.S. 950 (1963); E. Owens & G. Ball, *The Indirect Credit*, 4 (Vol. I, 1975).

a foreign subsidiary currently distributes its entire after-tax earnings to its parent, the same tax results would occur as if the parent had operated through a branch.[21] Certain provisions of the indirect credit computation (for example, the "gross-up" of foreign tax paid) are designed toward this end. Nevertheless, several aspects of the indirect credit are not designed to equate subsidiary and branch treatment.

Most fundamentally, the indirect credit computation reflects the U.S. tax concept that a shareholder of a corporation is generally not taxed currently on corporate taxable income, but is taxed when "earnings and profits" are distributed. This concept generally allows U.S. shareholders of foreign corporations to obtain deferral of U.S. tax on foreign corporate earnings (subject to the requirements of subpart F and certain other current inclusion rules). At the same time, it means that the measure of a U.S. shareholder's income from the foreign corporation is not based on current U.S. taxable income, but on "earnings and profits" or "accumulated profits" of the foreign corporation.

Several different policy approaches can be taken to the indirect credit. When it was originally enacted in 1918, the indirect credit was available only to a U.S. corporation that controlled a foreign corporation and only with respect to foreign taxes paid by that first-tier foreign corporation. This approach arguably afforded the credit only to those U.S. corporations effectively operating abroad in corporate rather than branch form.

Since that time, the indirect credit has been made more widely available. Today, U.S. control of the foreign corporation is not required and the credit is generally available to any 10 percent U.S. corporate stockholder for taxes paid through the third foreign corporate tier, if a minimum indirect ownership is present. The trend has been toward granting the credit to any U.S. corporation owning stock in a foreign corporation since foreign taxes reduce the dividends received. Restrictions on stock ownership and tiers of foreign corporations are based in administrative concerns.

A third approach, not reflected in present law, would be to grant the indirect credit only to the extent that the income on which foreign tax is paid is subject to U.S. tax in the year earned, as is the case with a foreign branch. Under this approach, deferral of U.S. tax on the foreign earnings would be viewed as capable of reducing the U.S. tax burden below that of a branch and thus reducing the level of double taxation.[21a] (The actual benefit of deferral would depend on the particular dividend policies of the companies.) The benefit of an indirect credit would thus be viewed as an alternative to the benefit of deferral. Some would contend that this approach might discourage foreign investment.

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[21] The tax eligible for the credit in the case of a subsidiary, as in the case of a branch, may be higher or lower than the U.S. tax on the same income. The eligible tax will be combined with other foreign taxes considered paid by the U.S. corporation and will be subject to the applicable limitation (overall under present law) based on the ratio of foreign source to worldwide income.

[21a] For a summary of these approaches, see E. Owens & G. Ball, *The Indirect Credit*, 329–332 (Vol. II, 1979).

Deficits

When a foreign subsidiary has profits (subject to foreign tax) in some years and deficits in other years and does not distribute all its earnings currently, a portion of the foreign tax may never be creditable. For example, although the deficits may generate no foreign tax, they also may not reduce the foreign tax under foreign law in the profitable years (e.g., the foreign country does not allow a loss carryback). In such a case, even if the subsidiary pays out all its net after-tax earnings at the end of the several years, the Internal Revenue Service takes the position that less than all the foreign taxes paid over those years will be eligible for the credit. This is because the deficit will reduce "accumulated profits" for the prior years in which the foreign taxes were paid, thus reducing the total amount of creditable taxes. In a branch situation with foreign income taxed currently, the result would differ.

Example (46% U.S. tax rate)

	Branch		Foreign Subsidiary		
	Income	Foreign taxes	Income	Foreign taxes	Accumulated profits (prior to foreign taxes)
Year 1.....	100	23	100	23	100
Year 2.....	100	23	100	23	100
Year 3.....	(100)	0	(100)	0	(100)

In the branch situation, the company in year 1 has 100 of foreign income (subject to tentative U.S. tax of 46), and an offsetting foreign tax credit of 23. The same situation occurs in year 2. In year 3, the 100 loss is carried back to year 1 and eliminates all U.S. tax, creating a 23 excess foreign tax credit that is carried forward and offsets the remaining 23 of U.S. tax in year 2. The company has received net foreign earnings, after foreign taxes, of 54, has paid total foreign taxes of 46, and has received a full U.S. credit for those taxes, producing a combined U.S. and foreign tax of only 46.[22]

In the subsidiary situation, if the subsidiary distributes all its after-tax net earnings (54) at the end of year 3, the indirect credit computation deems the distribution to come wholly from year 1 accumulated profits because the year 3 deficit has eliminated year 2 accumulated profits (Rev. Rul. 74-550). Accordingly, the creditable tax is 54/77 x 23 or 16.13. The U.S. dividend, after gross-up for this tax, is 70.13 (54 plus 16.13). The tentative U.S. tax is 32.26; and the U.S. tax after credit is 16.13. The parent has received total after-tax foreign earnings of 54 and has paid a total foreign tax of 46,

[22] For simplicity, the example assumes a foreign tax rate that by itself will not trigger the overall limitation on creditability of foreign taxes. It is assumed that there are no earnings and profits at any time during year 3.

but only a part of the foreign tax is creditable so that a combined U.S. and foreign tax of 62.13, rather than 46, has been paid.

The Administration pooling proposal would alleviate this result. When the 54 distribution is made to the parent, the total foreign taxes paid would be the aggregate for all years (46) and the total accumulated profits prior to foreign taxes would be the aggregate for all years (100). After reducing accumulated profits for the 46 of foreign taxes paid, the indirect credit allowed would be 54/54, or 100% of the 46 of foreign taxes paid.

Changes in foreign effective tax rate

Apart from the impact of deficits, present law also affects the availability of the indirect credit when a foreign corporation's effective foreign tax rate changes for any reason (for example, where foreign tax rates rise as a result of the end of a "tax holiday" or otherwise; where foreign tax rates decline; or where the effective foreign tax rates otherwise fluctuate from one year to another). It is advantageous under present law for foreign subsidiaries, where possible, to accumulate their earnings in years in which their effective foreign tax rate is low and dividend their earnings to U.S. parent corporations in years in which their effective foreign tax rate is high, rather than distributing their earnings on an annual basis with more constant dividends. Since, for purposes of computing the foreign taxes attributable to a dividend, the dividend is deemed distributed out of the subsidiary's earnings and profits for the current year first, drawing with them the foreign taxes with respect to those earnings, and then are treated as being derived from each preceding year, the distribution of dividends only in high tax years yields a higher foreign tax credit than the average foreign taxes actually paid by that foreign subsidiary over a period of years. This result would not occur in the case of a direct branch operation, since all income would be subject to U.S. tax currently and foreign taxes eligible for the credit would be taken into account currently.

Present law thus provides opportunities for the so-called "rhythm method" of dividend distributions from foreign subsidiaries. For example, suppose a U.S. parent corporation has two foreign subsidiaries and the foreign tax rate for each can be significantly lowered in one year at the cost of an increased rate in the next year, through timing the allowance of deductions and the recognition of income. Matters can be arranged so that the high and low tax years of the subsidiaries alternate, and the U.S. parent corporation takes the dividends it needs each year from the particular subsidiary that in that year has a high foreign rate.

The Administration proposal would limit such possibilities by in effect treating earnings and profits as fungible. The proposal would average the high-tax years and the low-tax years of the foreign corporation in determining the foreign taxes attributable to the dividend.

The 60-day rule for actual distributions under present law also facilitates particular types of "rhythm method" distributions under certain foreign tax regimes. For example, some foreign countries (e.g., Germany) allow a corporate level deduction for dividend distributions, imposing the full corporate tax only on retained earn-

ings. A foreign subsidiary in such a country can accumulate earnings in one year (paying a high effective rate of foreign tax for that year). If the subsidiary then distributes earnings to its U.S. parent in the first 60 days of the following year, the distribution of earnings will itself reduce the effective foreign tax rate in the year of distribution, so that the average effective rate for the two years will be significantly lower than in the first year. However, the distribution will be deemed to carry out a portion of the prior year's high foreign taxes, for U.S. indirect tax credit purposes. Even without pooling, elimination of the 60-day rule would limit this particular planning possibility.

Some contend that pooling would be administratively difficult because it would require the taxpayer (and the Internal Revenue Service, in the case of an audit) to consider earnings and profits information over many past years to determine the correct amount of indirect credit. Prospective enactment (as the Administration proposes) would minimize any such burden, at least in the early years following enactment, and would place companies now owned by U.S. persons on clear notice of the recordkeeping requirements for the future. Even under present law, such records would be necessary in certain situations, such as a sale of stock or liquidation of a company that had been a controlled foreign corporation (sec. 1248).

It is also contended that even prospective pooling would not eliminate potential administrative burdens in the case of a foreign corporation acquired by a U.S. corporation from former foreign shareholders. In such a case, it is argued that records for periods prior to the acquisition may not be readily conformed to U.S. earnings and profits concepts and that present law would require a determination of such earnings and profits only in limited instances—for example, if dividend distributions were sufficiently large to be considered made out of pre-acquisition earnings and profits; or if there were a cumulative deficit, so that the inclusion of subpart F income could be affected (sec. 952(c)). Some have suggested that a specified minimum U.S. shareholder interest might be required during a year before the earnings and profits of such year would be included in the "pooling" approach. It has also been suggested that a deemed-paid credit might not be appropriate for pre-acquisition earnings in any case.

It has been suggested that some type of limited pooling (e.g., pooling over a three-year or other relatively short specified period) might be less administratively burdensome.[22a] Others contend such an approach would not effectively deal with the problem of averaging (in "tax holiday" and other variable rate situations) or with the deficit issue, and would provide little certain benefit.

[22a] Others have suggested that the reporting of a dividend from the foreign corporation might permit the U.S. taxpayer to "freeze" for the future its computations of foreign taxes and accumulated profits used in that reporting, after the passage of a certain period of time without an Internal Revenue Service change to such computation. It has been questioned whether this might permit too much taxpayer flexibility in the absence of a thorough audit of each case.

Other variances of U.S. earnings and profits from foreign taxable income

It is common for foreign tax to be levied on a base that differs from U.S. earnings and profits and that differs from the amount that would have been treated as U.S. taxable income if earned by a branch. The Tax Reform Act of 1984 ("1984 Act") increased the number of situations in which U.S. earnings and profits or accumulated profits attributable to a particular year will exceed U.S. taxable income and, frequently, foreign taxable income as well. Under the 1984 Act, for example, earnings and profits are increased in the year of an installment sale to reflect the total amount of gain on the sale (as if the installment method were not used) even though under the installment method a substantial amount of the gain may not be subject to tax until later years. Similarly, taxpayers using the completed contract method of accounting must compute earnings and profits under the percentage of completion method. Also, in computing earnings and profits under the 1984 Act, LIFO inventory accounting is in effect not permitted. Furthermore, interest, taxes and other charges incurred during the construction of property must generally be capitalized rather than deducted, and intangible drilling costs and mineral exploration expenses must be capitalized.

All of these 1984 Act changes would increase the earnings and profits of a foreign subsidiary prior to the year in which a branch would be treated as having U.S. taxable income. In some cases (for example, installment sales taxed abroad only as payments are received), a transaction may increase earnings and profits of a foreign subsidiary prior to the year in which the foreign country will tax the related income. In other cases (for example, situations in which a foreign country does not permit the completed contract method of accounting or LIFO inventory methods for income tax purposes) the 1984 Act changes may match earnings and profits for U.S. purposes more closely to the year in which the foreign country taxes the related income.

The 1984 Act changes were principally intended to increase "earnings and profits" for purposes of determining the amount of a corporate distribution that would be taxed to the recipient as a dividend; [23] however, as Congress recognized, they also affect the computation of the indirect foreign tax credit by increasing the denominator of the indirect credit fraction.[24] This may affect different taxpayers in different ways, depending on the nature of the foreign items (e.g., installment sales or completed contract method transactions), the foreign tax base, and the dividend policies of a subsidiary. In some situations (for example, a growing foreign subsidiary

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[23] S. Rep. No. 98-169 (Vol. 1), 98th Cong. 2d Sess. 197-202 (1984); H.R. Rep. No. 98-861, 98th Cong. 2d Sess. 835-842 (1984).

[24] Congress was aware that the changes would affect the amount of foreign tax eligible for the indirect tax credit, as well as the amount of certain deemed dividend income under subpart F and related provisions. Congress provided that the changes with respect to installment sales, use of the completed contract method, and LIFO inventory adjustments would not apply for any purpose to certain foreign corporations (generally those deriving less than 20 percent of gross income from U.S. sources) until taxable years beginning in 1986. The delay was intended to give both the Treasury and affected corporations the opportunity to consider how those earnings and profits changes should apply to such foreign corporations. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 841 (1984).

corporation with continually increasing foreign installment sales or that generate aggregate earnings and profits each year in excess of amounts received and subjected to foreign tax) it is contended that under present law the effect of computing the creditable foreign tax on the basis of the expanded earnings and profits is not only a deferral but in effect a complete loss of some portion of the credit for foreign taxes paid so long as installment sales continue to increase, even if the subsidiary distributes its full after-tax foreign receipts to its U.S. parent each year. By contrast, a branch would receive a full credit for foreign taxes paid each year. It is contended that the Administration's pooling proposal would not minimize this effect but instead, could exacerbate it. Some representatives of companies in this situation contend that earnings and profits as used in the denominator of the indirect credit fraction should not include the 1984 Act earnings and profits expansions.

Others contend that it is in principle inappropriate to measure the "earnings and profits" from which foreign taxes are considered paid by a measure different than that used to determine the amounts included in U.S. income. It is argued that a U.S. corporation with a foreign subsidiary that seeks to relate foreign tax to U.S. taxable income concepts rather than to U.S. earnings and profits concepts can do so by operating in branch form rather than corporate form.

10-percent voting stock ownership test

Under present law, a U.S. corporation must own 10 percent or more of a directly owned (first-tier) foreign corporation's voting stock in order to claim an indirect credit for foreign taxes paid by the foreign corporation. In determining whether this test is met, there is no attribution of ownership. For example, the test may not be met by aggregating stock owned by different members of a U.S. corporate group, regardless of whether the group files a consolidated federal tax return or whether all subsidiary members are wholly-owned.[25]

If a first-tier foreign corporation owns a second-tier foreign corporation, the indirect credit is not available for taxes paid by the latter unless the first-tier corporation directly owns 10 percent of the second tier-corporation's voting stock. A similar rule applies between a second and a third-tier corporation. In addition, the U.S. parent must have a minimum indirect ownership in every case (by attribution through the tiers) of at least 5 percent.

Different rules apply, however to determine when a U.S. corporate stockholder of a controlled foreign corporation must include certain income of that foreign corporation in income as a deemed dividend under subpart F of the Code (Sec. 951(d)). For that purpose, the U.S. corporation must own 10 percent of the voting power

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[25] Rev. Rul. 85-3, 1985-2 I.R.B. 4.

of the foreign corporation;[26] however, attribution rules apply. For example, if 5 percent of the voting stock of foreign corporation X is owned directly by U.S. corporation A, another 5 percent is owned by A's wholly-owned foreign subsidiary, and 45 percent is owned by an unrelated U.S. person, foreign corporation X will be a controlled foreign corporation and U.S. corporation A will be deemed to own 10 percent of X's voting stock and required to include in income as a deemed dividend a share of X's subpart F income. However, U.S. corporation A will not meet the 10 percent test for the indirect foreign tax credit and thus will not be able to credit any portion of foreign taxes paid by X.

It has been suggested that the 10 percent test for determining whether a U.S. corporate shareholder is eligible to claim an indirect foreign tax credit should be changed to require the same ownership required for subpart F inclusion under Code section 951(d). This would reduce the situations in which a U.S. corporate shareholder is required to include an amount of foreign corporate earnings and profits in income but is not allowed the indirect tax credit.

Personal holding company stock

The Internal Revenue Service has ruled that a U.S. corporation that meets the 10 percent indirect tax credit stock ownership requirement with respect to a foreign personal holding company and that is required to include an amount of the foreign personal holding company's income as a deemed dividend for U.S. tax purposes under section 551 may not claim an indirect foreign tax credit for foreign taxes paid by the foreign personal holding company. However, an indirect tax credit can be claimed with respect to an undistributed "consent" dividend under section 565.[27]

The Internal Revenue Service position is based on the following statement in the background of the Revenue Act of 1937 (which first required U.S. shareholders to include undistributed foreign personal holding company income as dividend income): "American shareholders should not be allowed any credit against their Federal income taxes for foreign income taxes, if any, paid by the foreign personal holding company in respect to the undistributed adjusted net income returned by them".[28] The expressed rationale for this statement was that "[t]he allowance of such credit is not administratively feasible although it might seem equitable under the circumstances."[29]

At the time the statement was written, the existing indirect foreign tax credit provisions allowed an indirect credit only if a U.S.

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[26] In order for the foreign corporation to be a controlled foreign corporation to which subpart F applies, U.S. shareholders directly or indirectly owning 10 percent or more of the voting power must together also directly or indirectly own more than 50 percent of the voting power of the foreign corporate stock.

[27] Rev. Rul. 74-59, 1974-1 C.B. 183.

[28] *Report of the Joint Committee on Tax Evasion and Avoidance of the Congress of the United States*, H.R. Doc. No. 337, 75th Cong., 1st Sess. 18 (1937). The proposals in the report formed the basis for the foreign personal holding company provisions of the Revenue Act of 1937.

[29] *Idem.*

corporation owned a majority of the shares of a foreign corporation. The Revenue Act of 1951 reduced the requisite indirect credit stock ownership to 10 percent. When Congress enacted the subpart F controlled foreign corporation provisions in the Revenue Act of 1962, and required U.S. shareholders to include certain undistributed earnings in income as dividends, Congress allowed certain 10 percent U.S. corporate shareholders to claim the indirect credit with respect to such dividends.

Some have suggested that a qualifying U.S. corporation should be entitled to claim the indirect foreign tax credit with respect to amounts that it must report as a dividend, including undistributed foreign personal holding company income. Others have suggested that it may be appropriate for the Internal Revenue Service to define "dividend" differently for purposes of the credit where there is no consent dividend, thus permitting double taxation to occur as a penalty.

F. Foreign and U.S. Losses

Present Law and Background

Foreign loss rules

As discussed in B., above, the per country foreign tax credit limitation rules of prior law permitted a taxpayer first to use the entire amount of a net loss incurred in any foreign country to reduce its U.S. taxable income. The taxpayer received a second tax benefit when, in a later year, it earned income in the loss country and that country imposed tax on the income at a rate higher than the U.S. rate and had no net operating loss carryforward provision. A full foreign tax credit was allowed for that tax, eliminating the U.S. tax on the income, even though the earlier loss had reduced U.S. taxable income and, thus, U.S. tax, also. To eliminate this double tax benefit, Congress repealed the per country limitation in the Tax Reform Act of 1976.

Under the overall foreign tax credit limitation, a taxpayer first uses a net loss incurred in any foreign country to reduce its income from other foreign countries. If a taxpayer's net foreign losses exceed its foreign income the excess ("overall foreign loss") reduces the taxpayer's U.S. taxable income. Prior to the Tax Reform Act of 1976, if a taxpayer with an overall foreign loss in one year later earned income abroad on which the taxpayer paid foreign tax, a foreign tax credit generally was allowed for the full amount of that tax even though the earlier overall foreign loss had reduced the taxpayer's U.S. taxable income. If the taxpayer's effective foreign tax rate was at least equal to the U.S. rate and the foreign countries in which its earlier losses originated had no net operating loss carryover provisions, the taxpayer received a second tax benefit as a result of that full foreign tax credit because the credit eliminated the U.S. tax on the subsequently earned income. To eliminate this double tax benefit, Congress enacted the overall foreign loss recapture rule in the Tax Reform Act of 1976.

Under the overall foreign loss recapture rule, a portion of foreign income earned after an overall foreign loss year is treated as U.S. income (Code sec. 904(f)). Foreign income up to the amount of the

overall foreign loss may be so treated. However, unless the taxpayer elects a higher percentage, no more than 50 percent of the foreign income earned in any particular year will be treated as U.S. income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an overall foreign loss year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

Oil and gas extraction losses incurred abroad are treated separately from other foreign losses. A net extraction loss incurred in any foreign country first reduces extraction income from other foreign countries. If a taxpayer's net foreign extraction losses exceed its foreign extraction income, the excess ("overall foreign extraction loss") first reduces the taxpayer's other foreign income, then the taxpayer's U.S. taxable income. Overall foreign extraction losses are subject to a separate loss recapture rule that operates in substantially the same manner as the general foreign loss recapture rule (sec. 907(c)(4)).

U.S. loss rules

Under present law, an overall U.S. loss reduces a taxpayer's foreign income, just as an overall foreign loss reduces a taxpayer's U.S. income. An overall U.S. loss may be carried back to reduce taxable income in an earlier year or carried forward to reduce taxable income in a later year only to the extent that the loss exceeds the taxpayer's foreign income in the year incurred. Because an overall U.S. loss first reduces same-year foreign income and hence same-year U.S. tax, such a loss reduces the amount of foreign tax credits (and other income tax credits) that may be used in the year it is incurred and may therefore cause foreign tax credits (and other income tax credits) to expire unused. Under present law, U.S. income earned after an overall U.S. loss year does not restore any of the foreign income previously offset by the U.S. loss. That is, the amount of usable foreign tax credits is not increased in years following an overall U.S. loss year to compensate for the decrease in the amount of usable credits in the loss year. Under present law, two taxpayers with the same total taxable worldwide income and foreign taxes over a two-year period, one of which has an overall U.S. loss in one year and one of which does not, may pay different amounts of U.S. tax and may use different amounts of foreign tax credits over the two-year period.

Administration Proposal

Under the Administration's per country limitation proposal (discussed further in B., above), a net loss incurred in any foreign country would reduce taxable income earned in all other countries, including the United States (rather than U.S. taxable income alone), in proportion to the shares of worldwide taxable income of each of those other countries. The portion of the net loss allocated to income earned in a particular country would be further apportioned among separate and nonseparate limitation income amounts earned in that country.

Income earned in the loss country after the loss year—up to the amount of the loss—would be treated as if it had been earned in

the countries to which the loss was previously allocated, in proportion to that previous loss allocation. To the extent that that loss allocation, by reducing income from a particular foreign country, gave rise to additional excess foreign tax credits, the subsequent treatment of additional income as if it had been earned in that country would increase the amount of foreign tax credits usable later. To the extent that the loss allocation, by reducing U.S. taxable income or income from a particular low-tax foreign country, reduced U.S. tax liability in the loss year, the subsequent treatment of additional income as if it had been earned in the United States or in the low-tax foreign country would result in the recapture of some or all of the U.S. tax revenue lost in the loss year. This rule would replace the present foreign loss recapture rule.

The proposal also would repeal the separate present law rules governing the treatment of foreign oil and gas extraction losses, including the foreign extraction loss recapture rule.

An overall U.S. loss would reduce foreign income as it does under present law. For per country limitation purposes, the U.S. loss would be prorated against income earned by the taxpayer in different foreign countries in proportion to the shares of worldwide taxable income of each of the countries. In addition, the proposal would add an overall U.S. loss recapture rule. Under this rule, a portion of U.S. income earned after an overall U.S. loss year would be treated as foreign income. The additional foreign income would be allocated among the income accounts of the various foreign countries in which the taxpayer operates in proportion to the previous U.S. loss proration.[30]

Analysis

Foreign loss allocation rules

As discussed above, under prior law per country limitation rules, a net foreign loss incurred in any foreign country first reduced U.S. taxable income and, therefore, generally, U.S. tax in the loss year. When income was subsequently earned in the loss country, however, that income (under certain circumstances) avoided U.S. tax too through the foreign tax credit mechanism. The foreign loss allocation rules proposed by the Administration as part of its per country limitation proposal would preclude this double tax benefit through a two-step process. First, by spreading a net loss incurred in any foreign country against income earned in other foreign countries, as well as against income earned in the United States, the proposal would limit the reduction of U.S. taxable income (and U.S. tax) in the loss year. Second, by treating some income earned in the loss country in a later year or years as U.S. income (up to the amount of the portion of the previous loss that *was* allocated to U.S.

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[30] In the 98th Congress, identical bills were introduced in the House and the Senate that would have established a U.S. loss recapture rule. The bills, H.R. 3140 (introduced by Mr. Gibbons) and S. 1584 (introduced by Senator Danforth), also would have extended the foreign tax credit carryover period and provided a first-in-first-out ordering rule for foreign tax credits. The Senate Finance Committee Subcommittee on Taxation and Debt Management held a public hearing on S. 1584 in September 1983. Congress took no further action on these bills during the 98th Congress. For additional discussion of S. 1584, *see* Joint Committee on Taxation, *Description of Tax Bills (S. 120, S. 1397, S. 1584, S. 1814, S. 1815, and S. 1826)* (JCS-46-83), September 23, 1983.

income), the proposal would reduce the foreign tax credit limitation for the loss country in such later year or years and thus limit the extent to which U.S. tax on the subsequently earned income could be eliminated by foreign tax credits.

Under these rules, U.S. tax is effectively deferred on the amount of U.S. income offset by the portion of a net foreign loss that is spread against U.S. income—until a later recapture of U.S. income occurs. Some argue that such deferral is inappropriate, that is, that *no* portion of a foreign loss should reduce U.S. taxable income, and that alternate loss allocation rules would eliminate the double tax benefit described above without permitting such deferral. For example, an approach rejected by the Administration—allocating a net loss incurred in any foreign country only against income earned later in that country—would accomplish this result. As the Administration has pointed out, however, this approach would lead to harsh results if a loss operation in a foreign country were abandoned without recouping the losses. This approach also would be inconsistent with the present law treatment of overall foreign losses which are allocated against same-year U.S. taxable income and recaptured later under the foreign loss recapture rule.

Another alternate approach—allocating a net loss incurred in any foreign country against income earned in all other countries *excluding* the United States first—also would eliminate the double tax benefit at issue, and would at least limit the deferral of U.S. tax described. This allocation rule would be similar in effect to the foreign loss allocation rules that apply today under the overall limitation. Opponents of this approach argue that losses incurred in foreign countries may be at least as closely associated with U.S. income as they are with income earned in other foreign countries and, therefore, this approach would disregard business realities. They argue that any detriment to taxpayers resulting from the present law application of similar loss allocation rules is mitigated in part by the tax advantages available under the overall limitation.

Some opponents of the Administration's proposal argue that the proposed foreign loss allocation rules would increase administrative responsibilities of taxpayers. They point out that, under the loss allocation rules, a taxpayer would have to keep a separate set of loss accounts for every foreign country in which it incurred net losses. Each set of accounts would have to record how, in the year incurred, the net losses were prorated against income earned in other countries, and the extent to which the losses had been recaptured to date with respect to each of the other countries.

Those favoring the foreign loss allocation rules proposed by the Administration respond that these or similar rules are essential to eliminate the double tax benefit sometimes available under prior law per country rules; that the proposed rules would provide taxpayers with a substantial benefit not available under present law by permitting a subsequent-year recapture of foreign income (and hence foreign tax credits) that is offset by net losses incurred in other foreign countries; and that the proposed rules would, where possible, simplify present law, for example, by eliminating the separate treatment of foreign oil and gas extraction losses.

It should be noted that the first alternate approach discussed above to the proposed loss allocation rules—allocating a loss incurred in any foreign country only against income earned later in that country—would avoid the particular administrative complexities of both the present law and proposed foreign loss allocation rules. However, it would require the maintenance of separate loss carryover accounts for each foreign country in which losses were incurred. The second alternate approach discussed above—allocating a loss incurred in any foreign country against income earned in all other countries excluding the United States first—would impose basically the same administrative burdens on taxpayers as the proposed rules would.

Repeal of separate rules for foreign oil and gas extraction losses

Under present law, an oil and gas extraction loss incurred in any foreign country first reduces extraction income from other foreign countries. In addition, an overall foreign extraction loss is subject to a separate foreign loss recapture rule. The Administration proposal would eliminate the separate treatment of foreign oil and gas extraction losses. Under the proposal, an extraction loss incurred in any foreign country would first offset other income earned in that country. A net loss incurred in any foreign country would be spread against income earned in all other countries, including the United States, and later recaptured to the extent it reduced U.S. taxable income.

As indicated above, proponents of the Administration proposal argue that eliminating the separate treatment of foreign oil and gas extraction losses would simplify present law. Others argue, however, that the separate treatment of extraction losses should be preserved. They point out that Congress enacted the current extraction loss rules in 1982 so that the rules segregating oil and gas income for foreign tax credit limitation purposes could be effectively applied. Those segregation rules reflect the fact that oil and gas income often bears an abnormally high rate of tax abroad. The purpose of the segregation rules generally is to prevent foreign taxes on oil and gas extraction income from being creditable against the U.S. tax on low-taxed, non-extraction income. Prior law, by allowing extraction losses incurred in one country not to offset extraction income in another, sometimes permitted an overstatement of creditable extraction taxes. This overstatement permitted foreign taxes on extraction income to offset the U.S. tax on foreign income from non-extraction sources, contrary to the general goal of segregating oil and gas extraction income and taxes. Opponents of the repeal of the current extraction loss rules argue that this type of offset would again be possible under the Administration proposal where a taxpayer earns both extraction and non-extraction income in a particular foreign country.

Proponents of the repeal respond that the incidence of taxpayers earning both extraction and non-extraction income in a particular foreign country is significantly less than the incidence of taxpayers earning both types of income worldwide and, therefore, the need for the separate extraction loss rules under a per country limitation regime like that proposed by the Administration is limited; the

cost in complexity of these rules would exceed the benefit under a per country regime, it is argued.

U.S. loss recapture rule

Example A shows how, under present law, two taxpayers with the same total taxable worldwide income and foreign taxes over a two-year period, one of which has an overall U.S. loss in one year and one of which does not, may pay different amounts of U.S. tax and may use different amounts of foreign tax credits over the two-year period.

Example A (Present Law)

	Year 1	Year 2	2-year total
Taxpayer 1 (overall U.S. loss):			
Foreign income (loss)	$100	$100	$200
U.S. income	(100)	100	0
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	46	46	92
Pre-credit U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 46	46
Net U.S. tax	0	46	46
Excess foreign tax credit	46	0	46
Taxpayer 2 (no overall U.S. loss):			
Foreign income (loss)	100	100	200
U.S. income	0	0	0
Worldwide taxable income	100	100	200
Foreign tax (46 percent)	46	46	92
Pre-credit U.S. tax (46 percent)	46	46	92
Allowable foreign tax credit	46	[2] 46	92
Net U.S. tax	0	0	0
Excess foreign tax credit	0	0	0

[1] Foreign tax credit limitation: Foreign income ($100)/worldwide taxable income ($200) multiplied by U.S. tax ($92) equals $46.

[2] Foreign tax credit limitation: Foreign income ($100)/worldwide taxable income ($100) multiplied by U.S. tax ($46) equals $46.

In Example A, each taxpayer has a total two-year worldwide taxable income of $200. Each has no U.S. taxable income for the two-year period. The taxpayer with an overall U.S. loss (Taxpayer 1) pays $46 in U.S. tax and $92 in foreign tax for the two-year period and accrues $46 of excess foreign tax credits. Thus, proponents of a U.S. loss recapture rule argue, Taxpayer 1's foreign income is subject to international double taxation—the very thing that the foreign tax credit is intended to prevent. Taxpayer 2, on the other hand, the taxpayer with no U.S. loss, pays no U.S. tax and $92 in foreign tax for the two-year period and accrues no excess foreign tax credits.

Enactment of a U.S. loss recapture rule would have the effect on Taxpayer 1 illustrated in Example B below. (Example B assumes that the rule enacted would permit taxpayers to have all their U.S.

income in a given year treated as foreign income—up to the amount of a prior year U.S. loss—and Taxpayer 1 chooses to have 100 percent of its U.S. income treated as foreign income in Year 2.)

Example B (With U.S. Loss Recapture Rule)

	Year 1	Year 2	2-year total
Taxpayer 1:			
Foreign income (loss)	$100	$100	$200
U.S. income	(100)	100	0
Worldwide taxable income	0	200	200
Foreign tax (46 percent)	46	46	92
U.S. tax (46 percent)	0	92	92
Allowable foreign tax credit	0	[1] 92	92
Net U.S. tax	0	0	0
Excess foreign tax credit	46	(46)	0

[1] Foreign tax credit limitation: Foreign income ($200, since the U.S. income in Year 2 is treated as foreign income)/worldwide taxable income ($200) multiplied by $92 equals $92.

Under a U.S. loss recapture rule, Taxpayer 1 would pay no U.S. tax and accrue no excess foreign tax credits for the two-year period. A comparison of Examples A and B shows that this is the same U.S. tax and excess foreign tax credit position as that of a taxpayer who does not have U.S. losses (Taxpayer 2 in Example A).

Proponents of a U.S. loss recapture rule argue that, without such a rule, the foreign tax credit system does not work properly: as indicated in Example A, the foreign income of U.S. taxpayers with overall U.S. losses arguably may be subject to international double taxation under certain circumstances. Those favoring a U.S. loss recapture rule suggest that Congress overlooked this problem when it considered and enacted the foreign loss recapture rule in 1976. They assert that the failure to enact a U.S. loss recapture rule amounted to a partial repeal of the foreign tax credit. The amendments required to implement a U.S. loss recapture rule, they argue further, are technical rather than substantive in nature.

Proponents of a U.S. loss recapture rule argue that consistency in the tax treatment of foreign and U.S. losses requires the adoption of such a rule. The foreign loss recapture rule eliminated disparities in the tax treatment of taxpayers that differed only in that some had overall foreign losses over a period of years and some did not. A U.S. loss recapture rule, they argue, would similarly eliminate disparities in the tax treatment of taxpayers that differ only in that some have overall U.S. losses over a period of years and some do not. In both cases, it is the required use of the annual accounting period that causes differences in income distribution over time to produce differences in U.S. tax liabilities among similarly situated taxpayers. Proponents of U.S. loss recapture point out that the tax law contains numerous provisions to mitigate accounting period-related differences in tax liabilities, such as the foreign tax credit carryback and carryover. The use of the annual accounting

period, they note, is arbitrary; it is used primarily for administrative convenience. They argue that taxpayers that are able to control the timing of income and loss can avoid the harsh effects of the annual accounting period and, therefore, such taxpayers enjoy an unfair advantage over taxpayers that are unable to control the timing of income and loss. In their view, the U.S. loss recapture rule is needed to establish symmetry in the rules governing losses.

On the other hand, it can be argued that the foreign loss recapture rule arose in response to certain specific problems in the operation of the foreign tax credit system with which U.S. losses are unconnected. The foreign loss recapture rule was enacted because overall foreign losses reduced U.S. tax while U.S. tax on foreign income in later years was reduced or eliminated by foreign income taxes imposed on that income. Often, the losses were start-up losses from new foreign investment by the taxpayer, and the foreign income tax in the second year resulted because the foreign country did not allow a carryover of the prior years' losses. The result was that the U.S. Treasury bore the cost of the foreign investment while the foreign country got the tax on the income from the investment. Thus, it could be argued that the foreign loss recapture rule protects the revenue by preventing taxpayers from gaining a double benefit at the expense of the U.S. Treasury.

Proponents of U.S. loss recapture argue, however, that additional reasons for enacting a U.S. loss recapture rule exist. They note that excess foreign tax credits may expire unused and argue that excess credits represent an additional cost of doing business abroad that can place U.S. companies at a competitive disadvantage vis-a-vis foreign companies. They cite U.S. losses as a significant reason for the excess credits of some companies. They point out that many U.S. companies would likely have increased excess credits in the future if the reduced corporate tax rates and per country foreign tax credit limitation proposed by the Administration were enacted. U.S. loss recapture, they argue, by reducing excess credits, would reduce the additional cost of doing business abroad just noted, and improve the competitive position of U.S. companies. In addition, since the focus of international tax planning by U.S. taxpayers is the maximization of foreign tax credit utilization, U.S. loss recapture would reduce current planning pressures. Others argue, however, that it might provide expanded planning opportunities that would allow some taxpayers to reduce U.S. tax in unintended ways. Also, some argue that the excess credit problem is adequately addressed by the Administration proposals (discussed in B., above) to extend the foreign tax credit carryover period from five to 10 years and allow taxpayers to elect to credit or to deduct foreign taxes on a country-by-country basis.

Those favoring U.S. loss recapture also have argued, however, that taxpayers that have overall U.S. losses and pay foreign taxes in the same taxable year may lose the full benefit of accelerated cost recovery system (ACRS) deductions and other investment incentives. ACRS deductions contribute to U.S. tax losses, which offset same-year foreign income. A taxpayer with high-taxed foreign income pays no U.S. tax on that income, because of the foreign tax credit. If this taxpayer also has a U.S. tax loss including ACRS deductions, those ACRS deductions do not reduce current

U.S. tax, and they are not available for carry over. If ACRS deductions are lost, it has been argued, taxpayers do not receive the tax benefit that Congress intended in enacting ACRS. U.S. loss recapture, they argue, would in effect return the benefits of ACRS to the taxpayers in later years.

Those opposed to U.S. loss recapture argue, on the other hand, that U.S. tax losses frequently exceed economic or book losses because of (among other tax rules) ACRS (which is generally not available for property used predominantly abroad) and certain of the present law income sourcing and deduction allocation rules (which arguably permit taxpayers artifically to characterize as foreign income what would otherwise be U.S. income and to reduce U.S. income with deductions that help generate foreign income (see discussion in C., above)). Therefore, they argue, foreign income offset by U.S. losses should not later be replaced (increasing the foreign tax credit limitation) through a recapture rule. The current year elimination of U.S. tax that occurs as a result of these tax losses, coupled with the ability to carry these losses back and forward to reduce taxable income in other years, represents an already substantial benefit to taxpayers, it is argued. Opponents of U.S. loss recapture point out that the Administration has proposed that ACRS be repealed and certain of the income sourcing and deduction allocation rules be modified; if enacted, these proposals, it is argued, would reduce U.S. tax losses considerably.

Some have suggested that the real problem is that overall U.S. losses offset foreign income, and overall foreign losses offset U.S. income. They have suggested an alternate system for computing worldwide taxable income be substituted for the present system. Under this alternate system, the aggregation of same-year U.S. and foreign income (and overall loss) would be eliminated, and overall U.S. losses would be carried back or forward in their entirety. Overall U.S. losses in a taxable year would no longer displace foreign tax credits that would otherwise have been utilized in that year. The carryback and carryover of U.S. losses in their entirety would preserve ACRS deductions. This system would eliminate any need for the foreign loss recapture rule as well as any need for a U.S. loss recapture rule. However, as indicated above, permitting foreign losses to offset only later year foreign income would produce a harsh result in instances where loss operations abroad are abandoned before losses are recouped. Also, this alternate system might impose tax liability on taxpayers with limited ability to pay, for example, taxpayers with no aggregate income for the year, but U.S. income offset by foreign losses.

The proposed U.S. loss recapture rule raises a further issue: the existence of recoverable U.S. losses in a company might be regarded as a financial asset by would-be acquiring corporations. Various provisions of present law restrict the transfer of other tax attributes, such as net operating losses and excess foreign tax credits, between acquired and acquiring corporations. A restriction on the use by an acquiring corporation of an acquired company's U.S. loss recapture benefits might be necessary to prevent trafficking in U.S. loss recapture benefits.

For a U.S. loss recapture rule to work properly, a requirement that creditable foreign taxes be paid on foreign income offset by

overall U.S. losses for recapture of such losses to occur also would arguably be necessary. In the absence of such a requirement, a U.S. loss recapture rule could be inconsistent with tax benefit principles. The reason is that, without such a requirement, U.S. loss recapture could take place with respect to U.S. losses that do not generate excess foreign tax credits. Since an important purpose of U.S. loss recapture would be to facilitate the use of excess credits resulting from U.S. losses, no recapture arguably should be allowed with respect to losses that generate no excess credits. Others argue, however, that even if no creditable foreign taxes are paid in an overall U.S. loss year, the U.S. loss normally restricts foreign tax credit utilization since taxpayers often have excess credits from other years that could be carried to the U.S. loss year, but for the U.S. loss. Therefore, permitting recapture of U.S. losses even in years when no foreign tax credit arises currently, they argue, would not conflict with tax benefit principles.

IV. SPECIAL TAX PROVISIONS FOR U.S. PERSONS

A. Americans Abroad

Special tax rules apply to U.S. individuals who work outside the United States. One set of rules applies to private sector workers, another to U.S. Government employees.

1. Private sector earnings

Present Law and Background

A U.S. citizen or resident is generally taxed on his worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under Code section 911, an individual who has his tax home in a foreign country and who is either present overseas for 11 out of 12 consecutive months or who is a bona fide resident of a foreign country for an entire taxable year can elect to exclude an amount of his foreign earned income from his gross income. The maximum exclusion is $80,000 in 1985, increasing to $85,000 in 1988, $90,000 in 1989, and to $95,000 in 1990 and thereafter.[31]

An individual meeting the eligibility requirements may also elect to exclude his housing costs above a floor amount. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The provision contains a denial of double benefits by reducing such items as the foreign tax credit by the amount attributable to excluded income.

Some U.S. citizens living abroad pay no income taxes to the countries in which they reside. The present foreign earned income exclusion of section 911 allows their income up to the appropriate ceiling to be free from U.S. tax as well.

U.S. citizens residing abroad and paying no income taxes to a foreign government receive a tax benefit in the form of lower overall U.S. taxes. The tax burden is zero if the their foreign earnings equal or are below the limitation and they have no other income. Where an individual's earnings exceed the limitation, his rates on the excess will be lower than a comparably compensated citizen living in the United States. This is because the first dollar of excess is treated, in effect, as the first dollar of income taxed at the lowest marginal rates. The same holds true for unearned income, that is, a U.S. citizen eligible for the foreign earned income exclusion will pay a lower rate of tax on his investment income than a similarly situated citizen all of whose earnings are subject to full U.S. tax.

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[31] This scheduled increase in the exclusion was set in the Deficit Reduction Act of 1984. Under the Economic Recovery Tax Act of 1981, the exclusion was scheduled to increase to $85,000 in 1984, $90,000 in 1985, and to $95,000 in 1986 and thereafter.

If the individual pays foreign income taxes on the excluded wages, those taxes cannot be credited against U.S. income tax liability on other foreign income. The value of the exclusion is, therefore, the difference between the tax savings and the amount of foreign tax credit which would have been claimed on the excluded amount in the absence of the exclusion. This difference is the greatest, and thus the exclusion has the greatest value, for taxpayers living in those countries where tax rates on the excludable portion are zero or much lower than the U.S. rate.

Some form of foreign earned income exclusion has been in the tax laws since 1926.

Administration Proposal

The Administration does not propose to change the benefits available for foreign earned income.

Other Proposals

1. S. 409 and H.R. 800 (Bradley-Gephardt) and S. 411 and H.R. 373 (Roth-Moore) would repeal all the special rules described above for foreign earned income.

2. H.R. 1377 (Stark) would reduce the foreign earned income exclusion (now $80,000) by 20 percent; and S. 556 (Chafee) would reduce it by 15 percent.

Other Possible Proposal

A possible proposal would be to retain the foreign earned income exclusion at statutory levels, but tax income that is not eligible for the exclusion at the higher, graduated rates that would apply if the excluded income were taxable.

Analysis

Proponents of an exclusion and other special rules for income earned abroad argue that, without such tax incentives, it would become difficult to recruit U.S. individuals to work abroad. They argue that the United States benefits when Americans work abroad because Americans are familiar with American goods and services and are likely to purchase American goods and services for their companies rather than foreign goods and services. They also argue that some expenses are borne by those working abroad to obtain services normally provided by State or local governmental agencies in the United States. One example of this latter aspect cited is schooling costs. Moreover, they argue that the elimination of the exclusion would have an adverse impact on U.S. companies operating overseas by increasing their cost of labor. They note that foreign countries, unlike the United States, generally exempt their citizens' foreign earnings.

Opponents of tax benefits for foreign earned income argue that they provide an unwarranted tax advantage to those U.S. citizens who live and work abroad compared with those who live and work in the United States. They argue that inclusion of foreign earned income in the U.S. tax base, like any measure to broaden the tax base, would allow some reduction of U.S. tax rates that apply to all

taxpayers and would thus benefit the economy. They argue that the effect of elimination of these benefits on the economy would be minor compared to the tax expenditure cost.

If Congress retains the foreign earned income exclusion, it may wish to examine the interaction between the exclusion and graduated tax rates. Congress could continue to apply the exclusion "off the top", that is, from the highest marginal brackets of the taxpayer. A deduction "off the top" simplifies the necessary computations. It also provides a greater incentive for taxpayers with high incomes because the excluded income would have been taxed at higher marginal rates. An exclusion "off the bottom", that is, from the lowest brackets, would give taxpayers earning the same amount of excludable foreign income the same tax savings. If the exclusion were "off the top," a taxpayer with income in excess of the exclusion could save much more in taxes than a taxpayer with the same amount of foreign earned income but no additional income.

2. U.S. Government employees

Present Law and Background

U.S. citizens employed as civilians outside the continental United States (and in some cases in Alaska and Hawaii) by the U.S. Government may exclude from their gross incomes certain allowances that supplement their base salaries. The allowances in question are designed primarily to cover certain living expenses. A number of expenses, such as moving expenses, generally would be deductible as employee business expenses under current law. But other allowances, notably those for housing, cost-of-living differentials, education expenses, and home leave travel, would be taxable income in the absence of the exclusion under section 912.

There are three categories of tax-free allowances. The first is foreign areas allowances. They fall into eight major groups: living quarters, cost-of-living differentials (by comparison with Washington, D.C.), education of dependents, travel, expenses associated with transfers, expenses associated with separation from the foreign service, representation expenses, and official residences (limited to certain officials).

The second category excluded from taxable income is cost-of-living allowances, if paid in accordance with regulations approved by the President, to employees stationed in foreign countries, in the U.S. territories and possessions, or in Alaska or Hawaii.

The third category of tax-free allowances is certain amounts paid to Peace Corps volunteers and their families as travel expense allowances and living allowances that do not constitute basic compensation.

The aggregate amount of allowances is not reported, nor does each employing agency report allowances separately in its budget. The Treasury Department has estimated that in 1975, approximately 100,000 civilian government employees received one or more allowances that are excluded from income under section 912. Approximately 40,000 of these persons were employed in foreign countries, about 20,000 in U.S. territories, and about 40,000 in

Alaska and Hawaii. About 60 percent of the total were civilian employees of the Department of Defense.

Administration Proposal

The Administration does not propose to change the benefits available for U.S. government employees.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt) and S. 411 and H.R. 373 (Roth-Moore) would repeal all the special rules described above for U.S. government employees.

Analysis

An overseas civilian employee receiving tax-free allowances may be better off than a comparable employee stationed in the United States. In many cases, the allowances that section 912 exempts cover not just the excess costs an employee incurs by being abroad (over what he or she would incur in the 48 contiguous States), but all costs involved. For example, the living quarters allowance provides for completely free housing, not just reimbursement for the housing costs in excess of those an employee would have incurred in the 48 contiguous States.

Advocates of the section 912 exemption for allowances received by Federal civilian employees argue that the presence of these allowances has caused the regular compensation of some employees, particularly foreign service personnel, to be lower than it otherwise would be. Opponents of the exemption reply that, if this is the case, these employees' compensation should be increased, with the result that the expenditure will appear on the budget of the employing agency. Advocates respond that if Congress removes this tax benefit, on-budget compensation increases may or may not occur. If they do not, the United States may find it very difficult to continue to employ enough qualified personnel to perform necessary services abroad for the United States.

B. Foreign Sales Corporations (FSCs)

Present Law and Background

Some income from exports can benefit from special tax rules. Two sets of rules apply explicitly to export income.

First, in general, the United States has limited its tax on income from exports when the exporter uses a "FSC"—a Foreign Sales Corporation. These rules generally reduce U.S. taxable income by at least 15 percent of export income or 1.19 percent of gross export receipts, whichever is greater. These export benefits are available, however, only if there is enough FSC-related activity outside the United States to satisfy detailed statutory requirements. Small FSCs (those claiming FSC benefits on income from no more than $2.5 million of gross export receipts) need not meet all these requirements.

Second, instead of using a FSC, an exporter generally may defer tax on at least 8/17 of export income by using a "DISC"—a Domes-

tic International Sales Corporation.[32] DISC benefits go primarily to small exporters, because tax deferral extends only to income from $10 million of a taxpayer's gross export receipts. The Federal Government collects annual interest on the deferred tax liability.

FSC and DISC benefits on exports of military goods are half the benefits available for other exports. Income from the export of designated property, including oil and gas, receives no FSC or DISC benefits.

A third, implicit tax benefit applies to export income earned by taxpayers with enough foreign tax credits. These taxpayers may be able to characterize about half of export income as foreign income and then to shelter it with those credits. A discussion of this provision appears as part of the discussion of the source rules, in Part III. C., above.

The FSC rules were enacted in the Deficit Reduction Act of 1984, effective generally on January 1, 1985, for taxable years ending on or after that date, and generally replaced the prior DISC rules enacted in 1971.

Administration Proposal

The Administration does not propose to change the FSC or DISC rules.

Other Proposals

1. S. 409 and H.R. 800 (Bradley-Gephardt) and H.R. 2222 and S. 1006 (Kemp-Kasten) would repeal FSC and DISC.

2. H.R. 1377 (Stark) would reduce FSC and DISC benefits by approximately 20 percent; S. 556 (Chafee) would reduce those benefits by approximately 15 percent.

Analysis

Advocates of the FSC and DISC rules argue that these rules increase exports and create or preserve jobs. They argue that other countries use a variety of devices to promote exports, and that the United States should respond in kind to keep our exporters competitive. In particular, they point to foreign rebates of indirect taxes like the value-added tax on exports. They argue that FSC and DISC rules are necessary because the United States provides few other meaningful export programs.

Opponents of the FSC and DISC rules contend that these rules are expensive in terms of revenue loss. They argue that the rules' impact in increasing exports is not worth this revenue cost. In addition, they argue that incentives for exports tend to increase the value of the dollar, and that increase then offsets the effect of export incentives.

Opponents further argue that these rules may violate the spirit of GATT—the General Agreement on Tariffs and Trade, which the United States has agreed to follow. Advocates of FSC and DISC contend that these rules fully comply with GATT.

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[32] This 8/17 figure is the product of 50 percent of export income, generally a minimum amount that the rules deem a DISC to earn, and 16/17, the amount of DISC income that may be deferred.

Some opponents of FSC and DISC oppose export incentives. They see no reason to encourage American business to sell business property to foreigners who may compete with Americans. They see no reason to encourage sales of American foodstuffs and consumer goods for foreign consumption rather than domestic consumption. Advocates of FSC and DISC respond that the imbalance of trade—the excess of imports over exports—weakens America's ability to produce and requires America to favor export sales over domestic sales.

Opponents of FSC and DISC see no reason to help exporters through the tax Code while not helping industries that compete with importers. Advocates of FSC and DISC reply that exporters are easy to identify, while industries that compete with importers are not.

C. Possession Tax Credit

Present Law and Background

Special provisions for the taxation of possession source income were first enacted in of the Revenue Act of 1921. These provisions were adopted primarily to help U.S. corporations compete with foreign firms in the Phillipines (then a U.S. possession), although in recent years most of the tax benefit is claimed by corporations located in Puerto Rico. Under the 1921 Act, qualified corporations deriving 80 percent or more of their income from U.S. possessions were exempted from income tax on their foreign source income. To qualify for the exemption, at least 50 percent of the corporation's income had to be derived from the conduct of an active trade or business (as opposed to passive investment income). Dividends paid to a U.S. parent from a qualified possession subsidiary were taxable while liquidating distributions were tax-exempt. Since the Puerto Rican Industrial Incentives Act of 1948, most possessions subsidiaries have operated under a complete or partial exemption from Puerto Rican taxes. Thus, a U.S. subsidiary in Puerto Rico could avoid both Federal and local tax by accumulating operating income until its grant of local exemption expired, and then liquidating into the mainland parent.

Tax Reform Act of 1976

Although the Phillipines ceased to be a U.S. possession in 1946, the special tax treatment of possession corporations remained unchanged until the Tax Reform Act of 1976.[33] In 1976, Congress indicated that Federal tax exemption had played an important role in Puerto Rican economic development. In the Finance Committee Report accompanying the 1976 Act,[34] the purpose of the special tax treatment of possession-source income was expressed as, "[to] assist the U.S. possessions in obtaining employment producing investment by U.S. corporations." The need for special tax incentives was

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[33] In 1954, these provisions were incorporated in sec. 931 of the Internal Revenue Code. Presently, the special tax rules apply to Puerto Rico, Guam, American Samoa, and the territories of Wake, Midway, and the Northern Mariana Islands. Separate, but similar, tax treatment applies to the U.S. Virgin Islands.

[34] Report of the Committee on Finance, United States Senate, on H.R. 10612, Sen. Rpt. 94-938 (June 10, 1976), p. 279.

attributed, in part, to the additional costs imposed by possessions status, such as the U.S. minimum wage standards and the requirement to use U.S. flag ships.

It appeared that several features of the possession tax system had a high revenue cost with little corresponding benefit to employment or investment in the possessions. To avoid U.S. tax on dividends paid to a mainland parent, possession subsidiaries invested accumulated earnings from operations in foreign countries, either directly or through the Puerto Rican banking system. Thus, the benefits of the possession tax exemption were not limited to investments in the possessions.[35]

The 1976 Act added section 936 to the Internal Revenue Code, which altered the taxation of U.S. chartered possession corporations. To more closely conform the tax treatment of possession income with the taxation of foreign source income, the exemption was converted to a credit. Thus, possession-source income was included in the definition of the parent company's worldwide income. However, in lieu of the ordinary foreign tax credit (for income taxes paid to foreign governments) a tax credit was enacted (the possession tax credit) for the full amount of U.S. tax liability on possessions source income. This is referred to as "tax sparing" since a credit is granted for foreign taxes not paid. Dividends repatriated from a possession subsidiary ("936 corporation") qualify for the dividend-received deduction, which allows tax-free repatriation of possessions income.[36]

The 1976 Act defined qualified possession-source investment income ("QPSII") to include only income attributable to the investment of funds derived from the conduct of an active trade or business in the possessions. The intent was to provide tax benefits to investment income only when this income resulted from an active investment in the possessions. Income from investments in financial intermediaries, such as possession banks, were made eligible for the credit only if it could be shown that the intermediary reinvested the funds within the possessions. In addition to the changes affecting domestic corporations under section 936, corporations chartered in the possessions that meet certain income source and activity tests are not considered controlled foreign corporations (sec. 957). Consequently the tax-haven type (Subpart F) income of such corporations is not taxed currently to controlling U.S. shareholders.

Tax Equity and Fiscal Responsibility Act of 1982

Despite the provisions in the 1976 Act, Congress in 1982 was concerned that the possession tax credit was costly and inefficient. According to the Finance Committee Report on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA):[37]

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[35] U.S. General Accounting Office, *Puerto Rico's Political Future: A Divisive Issue with Many Dimensions*, (March 2, 1981), GGD-81-48, p. 69.

[36] Companies eligible for the 100-percent dividend received deduction can repatriate possession-source income tax-free, while companies eligible for the 85-percent deduction are effectively taxed on 15 percent of possession-source dividends.

[37] "Tax Equity and Fiscal Responsibility Act of 1982," Report of the Committee on Finance, United States Senate, on H.R. 4961, Sen. Rept. No. 97-494, (July 12, 1982).

> "Treasury's three reports to date have confirmed the existence of two problems in that system: (1) unduly high revenue loss attributable to certain industries due to positions taken by certain taxpayers with respect to the allocations of intangible income among related parties, and (2) continued tax exemption of increased possession source investment income."

In addition, there was considerable uncertainty under prior law regarding the extent to which intangible assets could be transferred to a possessions corporation free of U.S. tax. In July of 1980, the Internal Revenue Service issued Technical Advice Memorandum 8040019 which stated that intangibles transferred to a possession subsidiary at less than a reasonable arm's-length price did not belong to the subsidiary, and the income derived therefrom was allocable to the parent corporation rather than the subsidiary.

The 1982 Act addressed these issues by (1) increasing the active income percentage requirement from 50 to 65 percent of gross income and (2) denying the credit on possession-source income allocable to intangibles transferred to the possessions. However, taxpayers are permitted to elect one of two optional methods of allocating intangible income: (1) a cost-sharing rule; and (2) a 50/50 profit split. Under the former option, a U.S. parent corporation is permitted to transfer manufacturing (but not marketing) intangibles to its possession subsidiary provided that the subsidiary makes a (taxable) cost-sharing payment to the parent. The payment represents the subsidiary's share of the company's worldwide direct and indirect research and development (R&D) expenditures in each product area. The possessions subsidiary's share of R&D expense is determined as the ratio of its third-party sales to those of all its affiliated companies within the same product area. The cost-sharing payment effectively increases the taxable income of the parent and, consequently, its tax liability.

Under the 50/50 profit split election, manufacturing and marketing intangibles may be transferred to a possession subsidiary provided that the subsidiary's income is limited to 50 percent of combined taxable income of the affiliated group, on a product-by-product basis. The combined taxable income associated with a product is determined as the excess of gross receipts (on sales of the product to third parties) over the direct and indirect costs of producing and marketing the product. Thus, to the the extent that combined taxable income represents a return on intangible assets, half of this intangible income is eligible for section 936 tax benefits.

To transfer intangible income, an irrevocable election must be made to use one of the two options. A single option must be selected for all products within a product area.[38] In addition, neither option may be used for a product which does not meet the significant presence test. A product satisfies the presence test if either (1) at least 25 percent of the value added to the product is a result of economic activity in the possessions, or (2) at least 65 percent of the direct labor cost for the product is incurred in the possessions. Finally, the 1982 Act generally prohibited possession corporations

[38] Export sales within a product group are exempt from this requirement.

from making future tax-free transfers of intangibles to foreign corporations.

Administration Proposal

In general

Subject to a transition rule, the Administration proposal would repeal the possession tax credit and replace it with a credit based on wages paid by manufacturing establishments in the possessions (and the U.S. Virgin Islands). For corporations that elect the wage credit, possession income would, in effect, be treated as U.S. source: (1) possession taxes would not be eligible for the foreign tax credit, but would instead be deductible; (2) possession-source income would be taxed currently; and (3) dividends paid by possession corporations to mainland corporations would be treated as U.S. corporate dividends (i.e., generally eligible for the 100-percent dividend-received deduction). For corporations that do not elect the wage credit, possession income generally would be taxed as foreign source income: (1) possession taxes would be eligible for the foreign tax credit (subject to a per-country limitation); (2) U.S. tax would be imposed on possession source income only when dividends are repatriated (except for tax-haven income under Subpart F); and (3) dividends paid by possession corporations would not be eligible for the dividend-received deduction. However, property used in the possessions would be eligible for the incentive depreciation system (CCRS) rather than the economic depreciation system that would be required for property used outside the United States. The proposal would repeal the current exception to the Subpart F rules for certain corporations organized in the possessions (sec. 957(c)).

Wage credit

The wage credit would equal 60 percent of wages up to the Federal minimum wage (currently $3.35 per hour), plus 20 percent of wages in excess of the minimum wage, up to four times the minimum wage.[39] Thus, the maximum wage credit would be 120 percent (60 percent plus 3 times 20 percent) of the minimum wage, or $4.02 per hour (at the current minimum wage). The wage credit would not be refundable but could be carried forward 15 years and used to reduce tax on non-Puerto Rican income. The wage credit election would be available on an equal basis to U.S. corporations with manufacturing operations in the Virgin Islands, preserving the present law parity between the Virgin Islands and the possessions.

Effective date

The proposal generally would be effective for taxable years beginning on or after January 1, 1986. However, corporations could elect to continue to use the present tax credit for five years with respect to possession-source income from products that were manufactured or validly designated in the previous taxable year. Qualified possession-source investment income from grandfathered ac-

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[39] The credit is computed with respect to the annual level of the minimum wage, assuming 52 40-hour weeks per year ($6,968 per year).

tivities would also be eligible for the present tax credit. Similar rules would apply to U.S. corporations with operations in the Virgin Islands. Earnings and profits accrued, and property acquired, in taxable years before January 1, 1986, would be exempt from the new application of the Subpart F rules (from the repeal of section 957(c) exemption).

Other Proposals

1984 Treasury Report

The 1984 Treasury Report[40] recommended that the possession tax credit be repealed effective January 1, 1987, and replaced a temporary wage credit which would be phased out after 1997. The wage credit would be 60 percent of the minimum wage per hour worked during 1987-1992, 50 percent in 1993, 40 percent in 1994, 30 percent in 1995, 20 percent in 1996, 10 percent in 1997, and zero percent thereafter.

S. 409 and H.R. 800 (Bradley-Gephardt)

The "Fair Tax Act of 1985," introduced by Sen. Bradley (S. 409) and Rep. Gephardt (H.R. 800), would repeal the possession tax credit effective January 1, 1987.

H.R. 1377 (Stark)

H.R. 1377 would disallow 20 percent of the benefits of the possession tax credit.

S. 556 (Chafee)

S. 556 would disallow 15 percent of the benefits of the possession tax credit.

Analysis

Over 99 percent of the possession tax credit is claimed by corporations with operations in Puerto Rico. In 1980, about one-third of the manufacturing employment in Puerto Rico was estimated to be attributable to section 936 companies, and the revenue cost of the credit, estimated by the Treasury Department to be $1.3 billion, amounted to about 12 percent of Puerto Rico's gross domestic product. Despite the credit, the growth rate of Puerto Rican income has slowed substantially since 1973, and the unemployment rate has increased to over 20 percent.

The Administration proposal recognizes the importance of the possession tax credit to the Puerto Rican economy, but argues that it is an inefficient and complicated system for stimulating employment. The Administration proposal notes that the credit has doubled since 1972 (after adjusting for inflation) while Puerto Rican manufacturing employment has not increased. According to Treasury Department statistics, the tax credit amounted to over $22,000 per possession corporation employee in 1982, over 50 percent more than the average employee earned in that year ($14,210). Fourteen

[40] Dept. of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 2, (November 1984).

possession corporations received tax credits in excess of $100,000 per employee.

The present system does not directly reward companies that increase employment in the possessions; instead it provides an incentive for U.S. corporations to generate (or shift) otherwise taxable income to the possessions. Thus, the Administration argues that a wage-based credit would be more effective than the current income-based credit. A similar conclusion was reached in 1975 by the Committee to Study Puerto Rico's Finances, appointed by the current Governor: [41]

> "In the past, U.S. investment flowed to the island to take advantage of both tax exemption and low wage rates. Investments were predominantly in industries with low capital-output and low capital-labor ratios, such as textiles and apparels, and thus provided relatively high levels of economic growth and employment. However, more recently Puerto Rican wage rates have increased relatively faster than skill levels, thus making Puerto Rico less attractive to investors. The result is that recent Puerto Rican investment is concentrated more heavily in the high capital-output and high capital-labor ratio industries, such as chemicals and pharmaceuticals, and thus provides less economic growth and employment. Hence tax exemption is increasingly the main reason for outside investment on the island, and the resulting investment is providing reduced benefits to the island."

A significant portion of the possession credit is attributable to income generated from passive investments. Under present law, qualified investment income may contribute up to 35 percent of the income of a possession corporation eligible for the possession credit. As a result of this provision and exemption from Puerto Rican tax,[42] deposits of possession corporations constitute over one-third of the commercial bank liabilities in Puerto Rico. Under the 1976 Act, investment income technically is qualified for the credit only if it is derived from funds reinvested in the possessions. However, since 1976 the Puerto Rican authorities have been concerned that these funds are being invested outside Puerto Rico (primarily in the Eurodollar market). The Puerto Rican Treasury Department issued regulations in 1980 and in 1984 that sought to prevent these funds from flowing out of Puerto Rico, but it remains unclear whether these deposits have, on balance, increased physical investment in Puerto Rico.[43]

The wage credit proposed by the Administration would provide a direct incentive to increase manufacturing employment in the pos-

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[41] Committee to Study Puerto Rico's Finances, *Report to the Governor,* (December 11, 1975), pp. 43.

[42] Under the Puerto Rican Industrial Incentives Act of 1978, income derived from a business operating under a tax-exemption grant may be reinvested free of Puerto Rican tax in certain assets including term deposits in qualifying Puerto Rican banks.

[43] The U.S. Treasury Dept. concluded in 1983 that, "The overall picture presented ... is that, at least between June 30, 1976 and June 30, 1981, section 936 and the related Puerto Rican regulations did not lead to any substantial growth in the net inflow of capital into Puerto Rico." Dept. of the Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation, Fourth Report,* (February 1983), p. 85.

sessions. As shown in Table 1, for an employee earning the minimum wage ($3.35 per hour), the wage credit would be $2.01 per hour, reducing the net wage cost to $1.34 per hour. For an employee paid twice the minimum wage ($6.70 per hour), the net wage cost after credit would be $4.02 per hour. These net wage rates are competitive with those in many of the Carribean basin countries, but not the poorest of these (e.g., Haiti and the Dominican Republic).

Table 1.—Comparison of Present Law and Wage Credit Proposal

[Wage rates in dollars per hour]

Present law wage	Wage credit	Net wage cost [1]	After-tax wage cost [2]	Reduction in After-tax wage cost [3]
$3.35	$2.01	$1.34	$0.90	73.2%
6.70	2.68	4.02	2.69	59.8
10.05	3.35	6.70	4.49	55.3
13.40	4.02	9.38	6.28	53.1

[1] Net wage cost equals present law wage less wage credit.
[2] After-tax wage cost equals net wage cost less tax savings from deduction of net wage cost (33 percent of net wage).
[3] Reduction in after-tax wage cost equals percentage difference between present law wage and after-tax wage cost under Administration proposal.

Under the Administration proposal, wages that are not credited would be deducted from corporate taxable income, reducing tax liability by 33 cents per dollar of deduction at the proposed 33-percent statutory rate. Thus, on an after-tax basis, the cost of hiring a minimum wage employee would fall from $3.35 to 90 cents per hour, a reduction in 73.2 percent from present law.[44] The after-tax cost of hiring an employee in the possessions would fall by over 50 percent even for relatively highly paid individuals earning four times the minimum wage ($13.40 per hour). As a result, the after-tax cost of labor relative to capital would decline very substantially in the possessions. In contrast to the distribution of tax benefits under present law, labor intensive operations would benefit the most under the wage credit proposal.

The Administration proposal acknowledges the goal of encouraging economic development in the possessions and thus recommends that the wage credit, indexed for future increases in the minimum wage, be a permanent feature of the U.S. tax system. Perceived abuses in the past have led to the complex eligibility and allocation rules in present law. A preliminary Treasury study of 1983 tax returns indicates that possession tax credit claimed increased over the previous year despite the $200 million decline in revenue cost that had been anticipated when Congress reformed section 936 in 1982. This raises the possibility that Congress will seek to modify section 936 in the future. In the past, it has been argued that

[44] Note that under present law, wages paid in the possessions do not reduce net tax liability because the possession tax credit effectively exempts possession-source income from U.S. income tax.

amendments to section 936, and ongoing tax litigation, have had a chilling effect on investment in the possessions. The wage credit is intended to be a more simple and stable system that would, after an adjustment period, result in higher employment levels in the possessions.

The wage credit concept has been criticized by the Puerto Rican government and by many U.S. companies with Puerto Rican operations. The main issue appears to be whether the proposed wage credit would be a more effective mechanism for promoting economic development in Puerto Rico than present law. Opponents of the wage credit proposal contend that the tax incentives under present law have been effective and have generated substantial employment in Puerto Rico. They argue that the capital-intensive industries, such as chemicals, have grown much faster than the labor-intensive industries, such as apparel and leather. Substitution of a wage credit for the possession credit would disrupt Puerto Rico's economic development, potentially slowing or reversing the growth of the higher technology industries. In addition, critics contend that even with the proposed wage credit, Puerto Rican wage rates would not be competitive with developing countries in Asia and the poorer Carribean islands. In this view, the present possession tax credit has contributed tangibly to Puerto Rican economic development, while the short-run effects of the proposed wage credit are acknowledged by Treasury to be disruptive, and the long-run effects are uncertain.

Critics of the Administration proposal, and of the 1982 amendments to section 936, also dispute the charge that the possession tax credit is an inefficient policy for promoting employment and economic growth in Puerto Rico. First, it is argued that Treasury's $22,000 per job revenue estimate is overstated. In this view, the estimate ignores jobs in the Puerto Rican service sector that are linked to the manufacturing operations of possession corporations. In response, it is noted that the wage credit proposal for manufacturing employees would also generate secondary employment in the service sector. Treasury's revenue estimate is also faulted on the ground that it assumes that possession-source income would be fully subject to tax if the credit were repealed. A more realistic assumption, it is argued, is that possession operations would move to low-tax foreign countries, such as Ireland, and that no U.S. tax would be collected as a result of deferral (i.e., certain foreign-source income is only taxed when dividends are repatriated). However, the transfer of intangible assets from Puerto Rico to a foreign country might trigger tax liability under section 367 of the Code (relating to transfers of property from the United States).

Proponents of the Administration proposal argue that the revenue cost of the wage credit proposal in 1982 would have been $3,772, less than one-fifth of Treasury's possession tax credit estimate of $22,000 per employee for that year.[45] Only if Treasury's

[45] In 1982, the average possession corporation employee earned $14,210 which, under the wage credit proposal, would have resulted in a credit of $5,629. The net credit, after reducing deductible wages by the credit (at an assumed 33-percent corporate rate), would have been $3,772.

estimate is over 5 times too large would the wage credit proposal be more costly than current law, measured on a dollar per job basis.

Puerto Rican authorities have also defended present law on the ground that it is essential for the success of the new "twin plant" program that is being promoted by the Puerto Rican government. Under this program, possession corporations would be encouraged to establish labor intensive manufacturing operations in the Carribean outside of Puerto Rico (to take advantage of low wage rates), with the more capital intensive finishing operations to be located in a twin plant in Puerto Rico. In this manner, it is argued that the possession tax credit could be used to encourage development in the entire Carribean Basin. Proponents of the wage credit system in the President's tax reform proposal argue that it is a more effective mechanism for increasing employment in Puerto Rico than the twin plant program. The wage credit could be extended to other Carribean countries if Congress desired to use the tax system to increase employment in these countries.

In conclusion, there is considerable controversy whether an income credit, a wage credit, or some combination of the two ultimately would be a more efficient stimulus for promoting economic growth in Puerto Rico. It has been argued that a tax subsidy for both labor and capital, such as contained in the Administration's enterprise zone proposal, would encourage more balanced development on the Island. The main economic argument for the wage credit approach is the sustained high rate of unemployment in Puerto Rico which is attributable, in part, to the extension of U.S. minimum wages to the possessions. The Administration proposal acknowledges that, ". . . there may be other ways to encourage employment in the possessions in a cost-effective way, or that there may be ways to restructure the wage credit to make it more efficient." There is some concern that abuses could arise under a wage credit system, for example, inflated payroll or wage give-back schemes designed to maximize the credit without increasing employment or salaries.

Unlike the Administration proposal, the 1984 Treasury Report proposed to replace the possession tax credit with a temporary wage credit that would terminate after 1997. The Bradley-Gephardt bill would terminate the possession tax credit and would not provide any new tax incentives for the possessions. Some have questioned whether tax benefits for the possessions, whether structured as a wage or an income tax credit, should be a permanent part of the U.S. tax system. Transfer payments and grants to Puerto Rico amounted to about $3.1 billion in 1981, considerably larger than the $1.3 billion of possession tax credits claimed in that year. It is argued that one of the goals of Puerto Rican economic development should be to terminate reliance on U.S. tax subsidies. However, others argue that a special relationship exists between the mainland and Puerto Rico as a result of commonwealth status and national security concerns. In this view, the relationship is too important to be jeopardized by an arbitrary phase-out of tax benefits.

D. Other Rules Governing U.S. Possessions

Present Law and Background

In general

The Commonwealth of Puerto Rico has enacted its own local income tax system, originally based on earlier U.S. tax rules, that does not correspond very closely to the current U.S. tax system. The other possessions, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, and the American Samoa, however, generally use the Internal Revenue Code as it changes from time to time as their local income tax systems. For corporate tax purposes, the United States treats each of these possessions as a foreign country, and each possession treats the United States as a foreign country. This system of taxation has acquired the name "mirror system" because each of these possessions uses the Internal Revenue Code (but substitutes its own name for the United States and, for some purposes, treats the United States as the United States treats possession). There are differences however, among the possessions that use the mirror system.

U.S. Virgin Islands

The United States requires the Virgin Islands, also, to use the mirror system. The Virgin Islands may impose a surtax of up to 10 percent on the mirror tax. The Virgin Islands can rebate its mirror taxes on its resident individuals and on U.S. and V.I. corporations that operate primarily in the Virgin Islands.

An "inhabitant" of the Virgin Islands pays tax to the Virgin Islands on its worldwide income, but pays no U.S. tax. Certain corporations qualify for inhabitant status, even some U.S. corporations. A V.I. corporation is not subject to the U.S. 30-percent withholding tax on passive income so long as it meets criteria designed to prevent the use of V.I. corporations as conduits for third country residents. A V.I. corporation is subject to the tax if 25 percent or more of its stock belongs to foreign persons, or if less than 20 percent of its gross income is derived from V.I. sources. This 20-percent test dovetails with a rule (mirrored from the Internal Revenue Code) that requires the Virgin Islands to withhold on payments from a V.I. corporation if 20 percent or more of its income is derived from V.I. sources.

Guam

A United States statute requires Guam to use the mirror code. Individual residents of the United States or Guam need file a tax return only with the place (the United States or Guam) where they resided on the last day of the year, however much time they spent in either place. Guamanian corporations are not subject to the U.S. 30-percent withholding tax, except Guamanian corporations that foreigners may use as conduits (under the rules that apply to V.I. corporations).

Northern Mariana Islands

The Commonwealth of the Northern Mariana Islands must use the mirror system in the same way that Guam does. This treatment generally began on January 1, 1985.

American Samoa

American Samoa has adopted its own income tax system. American Samoa has used the Internal Revenue Code, with minor amendments, as its internal income tax system.

Administration Proposal

U.S. Virgin Islands

The Administration proposal would clarify the operation of the mirror system in the Virgin Islands to prevent unintended results. It would repeal the V.I. inhabitant rule. It would allow the Virgin Islands to impose any nondiscriminatory local income taxes in addition to those it now imposes under the mirror system. It would provide for cooperation between the U.S. Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue. It would allow the Virgin Islands to rebate tax on U.S. corporations whatever the extent of their activities in the Virgin Islands. The Administration proposes that consideration be given to "authorizing the Virgin Islands to reduce or rebate the tax liability of certain foreign persons with respect to income derived from Virgin Islands sources."

As for individuals, the Administration would treat anyone who is a bona fide V.I. resident on the last day of the taxable year as taxable only in the Virgin Islands, and not in the United States. A U.S. individual (other than a V.I. resident) who derives income from the Virgin Islands would file two returns, one with the United States and one with the Virgin Islands, and would pay a pro rata amount of tax to each.

The proposal would alter the rules preventing foreigners from using V.I. corporations as conduits to avoid the U.S. 30-percent withholding tax. It would substitute a requirement that 65 percent of a corporation's income be effectively connected with a trade or business in a possession or in the United States in place of the 20-percent source of income requirement in current law.

Guam, the Marianas, and American Samoa

Guam and the Commonwealth of the Northern Marianas would be able to determine their own income tax laws regardless of the U.S. tax laws. This treatment would place them on a par with American Samoa. The Administration proposes that Guam and the Marianas implement tax systems that would raise "at least as much revenue" as their current mirror systems.

Residents of Guam and the Marianas who received income from outside those possessions would have to file U.S. tax returns. The United States would collect the tax on that non-possession income, but would transfer the money to the possession where the taxpayer resided.

For the purpose of the 30-percent withholding tax, the proposal would treat Guam and Marianas corporations as it would treat V.I.

corporations by providing that 65 percent of a corporation's income be effectively connected with a trade or business in a possession or in the United States.

The Administration proposes anti-abuse provisions to prevent the use of corporations in these possessions to avoid U.S. tax. It proposes coordination of taxes among these possessions, and exchange of information between each possession and the United States. It proposes that each possession receive taxes withheld on compensation of U.S. Government personnel stationed there.

Analysis

The Administration asserts that U.S. tax rules are not necessarily appropriate for the possessions, and that the mirror system is complex and susceptible to abuse. The proposal would retain, however, U.S. rules and the mirror system for the Virgin Islands, because the Virgin Islands Government wanted to retain U.S. tax law and the mirror while the other three possessions did not. (It is not clear whether all the possessions endorse the Administration proposal.)

It is not clear, as a practical matter, how the Administration would require Guam and the Marianas to maintain current levels of revenue collection. If these possessions failed to collect enough revenue, they would probably ask Congress for appropriations of funds to meet their revenue needs. Of course, Congress could satisfy itself that the possessions were raising adequate revenue before appropriating funds for the possessions.

Advocates of the mirror system argue that it represents a middle ground between full local autonomy, which the Administration proposes, and a direct extension of U.S. tax rules and IRS enforcement to the possessions. They contend that the combinations of U.S. rules and enforcement by the possessions maintains some certainty of self-funding while allowing the possessions some autonomy. Under current law, in some cases, however, the ability of the United States to insure enforcement of tax laws in the possessions is unclear. Therefore, it may now be unclear how well the possessions fund themselves.

The Administration proposal to consider authorizing the Virgin Islands to reduce taxes of foreign persons on V.I. income is not clear. For instance, it is not clear whether the Virgin Islands could reduce tax on passive income such as dividends. The United States does not eliminate tax on dividends paid to foreign investors, so it might not be appropriate for the Virgin Islands to do so.

V. TAXATION OF FOREIGN CURRENCY EXCHANGE RATE GAINS AND LOSSES

A. Present Law and Background

When a U.S. taxpayer uses foreign currency as a medium of exchange, gain or loss (referred to as "exchange gain or loss") may arise from fluctuations in the value of the foreign currency in relation to the U.S. dollar. This result obtains because foreign currency is treated as personal property, and not as equivalent to the U.S. dollar, for Federal income tax purposes.

The principal issues presented by foreign currency transactions relate to the timing of recognition, the character (capital or ordinary), and the geographic source (domestic or foreign) of exchange gains or losses. Another area of concern is the treatment of U.S. taxpayers that operate abroad through a branch or a subsidiary corporation that keeps its books and records in a foreign currency; here, the issues relate to the method used to translate results recorded in a foreign currency into U.S. dollars.

Most of the rules for determining the Federal income tax consequences of foreign currency transactions are embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application are provided by Treasury regulations and, in a few instances, the Code. The lack of a coherent set of rules for the treatment of foreign currency transactions results in uncertainty. The courts have addressed several issues by applying general Federal income tax rules that produce anomalous results when applied to exchange gain or loss (e.g., the treatment of exchange gain on repayment of a loan as income from discharge of indebtedness that is eligible for deferral, discussed below). Other issues are treated by old cases that are inconsistent with current case law, but that have not been expressly overruled (e.g., whether exchange gain or loss is integrated with gain or loss from an underlying transaction). Further, the IRS and the courts have taken contrary positions with respect to certain issues (e.g., whether a debtor's exchange gain or loss on repayment of a loan is capital or ordinary in nature). This state of affairs enables taxpayers to claim inconsistent tax treatment for similar transactions, relying on whichever authority provides the most advantageous result.

1. Foreign Currency Transactions

Foreign exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction.[46]

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[46] Exchange gain or loss can also arise where foreign currency is acquired for personal use. *See* Rev. Rul. 74-7, 1974-1, C.B. 198 (the IRS ruled that a taxpayer who converts U.S. dollars to a

Continued

Under the so-called "separate transactions principle," both the courts and the IRS require that exchange gain or loss be separately accounted for, apart from any gain or loss attributable to an underlying transaction.[47] The following discussion focuses on the present-law rules for determining the timing, character, and source of exchange gain or loss arising from foreign currency denominated liabilities or assets (including accounts payable or receivable) and hedging transactions.

Debt denominated in a foreign currency

Treatment of debtors

The authorities relating to a debtor's exchange gain or loss on repayment of a foreign currency loan provide a basis for claiming capital gains and ordinary losses. Further, in the case of business taxpayers, it is possible to claim that exchange gain is eligible for deferral as income from discharge of indebtedness. The rules regarding the source of an exchange gain or loss on repayment of a debt are unclear; although one reading of the law results in domestic source gain and foreign source loss in certain cases.

In general.—A taxpayer may borrow foreign currency to use in a trade or business (e.g., to satisfy an account payable) or to make an investment in a foreign country. At maturity of a loan denominated in a foreign currency, typically, the taxpayer must obtain units of the foreign currency—in exchange for U.S. dollars—to repay the loan. If the foreign currency increases in value before the repayment date, the amount of U.S. dollars required to retire the debt would exceed the U.S.-dollar value of the foreign currency originally borrowed, and the taxpayer would suffer an economic loss. Conversely, if the foreign currency depreciates in value, the taxpayer would be able to discharge the debt at a reduced cost (because fewer U.S. dollars would be needed to obtain the number of units of foreign currency originally borrowed); here, the taxpayer would realize an economic gain.

Example (1).—Assume a U.S. taxpayer borrows 24 million Japanese yen when the rate of exchange is 240 yen per U.S. dollar. Thus, the U.S.-dollar value of the loan is $100,000.[48] At maturity of the loan, the borrower must repay 24 million yen, without regard to fluctuations in the yen:dollar exchange rate.

If the exchange rate on the date of repayment were 220 yen per dollar (i.e., if the U.S.-dollar value of the yen increased to $.004545),

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foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency).

[47] The law on this point is fairly well settled, although there is a contrary line of older cases that provides authority for determining overall gain or loss by aggregating exchange gain or loss and gain or loss from the underlying transaction. Compare *National-Standard Co.* v. *Commissioner*, 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984) (where the taxpayer and the IRS stipulated that the separate transactions principle applied) with *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (where the U.S. Supreme Court determined that no net income was realized where the overall transaction generated a loss that exceeded an exchange gain on repayment of a foreign currency loan).There are two well recognized exceptions to the separate transactions principle: (1) a dealer in foreign exchange can use the lower of cost or value to determine foreign currency inventory, (Rev. Rul. 75-104, 1975-1 C.B. 18), and (2) a foreign branch of a U.S. taxpayer may translate unremitted foreign-currency denominated profits into dollars at the exchange rate in effect at the end of a taxable year, as described below.

[48] At the exchange rate of 240:1, the yen has a U.S.-dollar value of about $.004166. ($.004166 x 24 million = $100,000.)

there would be a loss of $9,080 because $109,080 would be needed to purchase 24 million yen.[49]

If the exchange rate on the date of repayment were 260 yen per dollar (i.e., if the U.S.-dollar value of the yen fell to $.003846), there would be a gain of $7,696, because only $92,304 would be required to obtain 24 million yen.[50]

It is generally acknowledged that an exchange gain or loss is realized when a foreign currency borrowing is repaid; the character and source of such gain or loss are less clear.

Character of exchange gain or loss on repayment.—Characterization as capital gain or loss depends on whether the discharge of a foreign-currency denominated obligation is viewed as the disposition of a "capital asset"[51] in a sale or exchange.

There is a substantial body of case law under which the use of property to discharge an obligation is treated as a sale or exchange of the property.[52] Under this line of cases, realized gain or loss is measured by the difference between the adjusted basis of the property transferred and the principal amount of the obligation. In light of this authority, because foreign currency is treated as property, the IRS has taken the position that the transfer of foreign currency to pay a debt constitutes a sale or exchange. Thus, in the IRS's view, capital gain or loss results, unless the foreign currency was used by the borrower as an integral part of its ordinary trade or business under the *Corn Products* doctrine.[53]

The Sixth Circuit Court of Appeals, as well as the U.S. Tax Court (with seven dissents), has rejected the IRS's view that repayment of a foreign currency loan constitutes a sale or exchange.[54] The Sixth Circuit relied on a 1939 case in which the U.S. Supreme Court held that the repayment of a debt is not considered a sale or exchange as to the creditor because the debtor does not receive property in the transaction.[55] Accordingly, because a sale or exchange is a prerequisite for capital gain or loss treatment, the Sixth Circuit held that an exchange loss on repayment of a foreign-currency denominated debt was an ordinary loss.

In an earlier case, the Sixth Circuit characterized exchange gain as income from the discharge of indebtedness.[56] Business taxpayers

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[49] ($.004545 x 24 million = $109,080.)

[50] ($.003846 x 24 million = $92,304.)

[51] The term "capital asset" includes all classes of property not specifically excluded by section 1221 of the Code. Foreign currency generally falls within the definition of a capital asset; however, under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), property that satisfies the literal language of section 1221 of the Code is not considered a capital asset if the property is used by a taxpayer as an integral part of a trade or business.

[52] *See, e.g., Kenan* v. *Commissioner*, 114 F.2d 217 (2d Cir. 1940) (where property was transferred in satisfaction of a legatee's claim against an estate); *Rogers* v. *Commissioner*, 103 F.2d 790 (9th Cir. 1939), *cert. denied*, 308 U.S. 580 (1939) (where property was transferred in return for cancellation of a note representing part of the purchase price); Rev. Rul. 76-111, 1976-1 C.B. 214. *See also United States* v. *Davis*, 370 U.S. 65 (1962) (where property was transferred to a spouse to discharge marital claims; this particular result was reversed by the Deficit Reduction Act of 1984).

[53] *See* Rev. Rul. 78-396, 1978-2 C.B. 114; Rev. Rul. 78-281, 1978-2 C.B. 204; G.C.M. 39294 (June 15, 1984).

[54] *National-Standard*, 749 F.2d. 369 (6th Cir. 1984), *aff'g* 80 T.C. 551 (1983).

[55] *Fairbanks* v. *United States*, 306 U.S. 436 (1939), *aff'g* 95 F.2d 794 (9th Cir. 1938) (the result in the case was reversed by statute).

[56] *Kentucky & Indiana Terminal Railroad Co.* v. *United States*, 330 F.2d 520 (6th Cir. 1969). *See also Gillin* v. *United States*, 423 F.2d 309 (Ct. Cl. 1970).

rely on this decision to defer the recognition of an exchange gain on repayment of a loan, by electing to reduce the basis of depreciable property by a corresponding amount (under sections 108 and 1017 of the Code), while immediately claiming exchange losses on similar transactions.

Finally, Judge Tannenwald has analogized the borrowing and repayment of a foreign currency to a "short sale" (in his dissent to the Tax Court's opinion in the *National-Standard* case), an analysis that supports capital gain or loss treatment unless the *Corn Products* doctrine applies.[57] In a short sale, the taxpayer sells borrowed property and later closes the short sale by returning identical property to the lender. Under section 1233(a) of the Code, gain or loss (computed by comparing the adjusted basis of the property used to close the short sale with the amount realized when the borrowed property was sold) is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer.

Source rules.—The source of an exchange gain or loss is important because of its impact on the calculation of the foreign tax credit limitation (as described more fully below, the amount of the credit is limited to the portion of U.S. tax liability that is attributable to foreign-source taxable income). Sections 861, 862, and 863 of the Code, and the accompanying regulations, provide rules for allocating income or gain to a domestic or a foreign source. Under the "title passage" rule, gain from the sale of personal property generally is treated as foreign source if the property is sold outside the United States; however, the re-sourcing rule of section 904(b)(3)(C) of the Code could apply to recharacterize a taxpayer's foreign source capital gain as domestic source gain for purposes of the foreign tax credit limitation.[58]

Losses from the disposition of capital assets or assets described in section 1231(b) of the Code (relating to property used in a trade or business) are sourced by reference to the source of the income to which the property ordinarily gives rise (Treas. reg. sec. 1.861-8(e)(7)). Otherwise, losses are generally apportioned between foreign and domestic gross income (e.g., on the basis of the location of the taxpayer's property).

Under the general source rules described above, gain on repayment of a foreign currency loan could be viewed as either foreign source (if ordinary in nature) or domestic source (if the repayment constitutes a sale or exchange and section 904(b)(3)(C) of the Code applies). The source of a loss on repayment is even less clear. Commentators have suggested the following possibilities: (1) exchange loss could be apportioned between domestic and foreign source income in the proportions that these amounts bear to each other in

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[57] *See National-Standard*, 80 T.C. at 567-568.

[58] Section 904(b)(3)(C) was designed to limit abuse of the "title passage" rule (i.e., the making of sales abroad solely to generate foreign source gains and thereby increase the foreign tax credit limitation), and applies unless (1) personal property is sold by an individual in a foreign country where the individual was resident, (2) in the case of any taxpayer, the property was sold in a country in which the taxpayer derived more than 50 percent of its gross income for the three-year period preceding the sale, (3) a foreign tax of ten percent or more was paid on the sale or exchange, or (4) a corporation sells shares in a second corporation in the country in which the second corporation is resident, and the second corporation derived more than 50 percent of its gross income from that country during the preceding three-year period.

the aggregate, (2) an analogue to the "title passage" rule could apply to support treatment as foreign source, or (3) the source of the loss could be determined by reference to the source of the gain or loss from the underlying transaction.

Multi-currency compacts.—Commentators have suggested that adverse U.S. tax consequences can be avoided by arranging to repay a foreign-currency denominated loan in U.S. dollars equivalent in value at repayment to the foreign currency borrowed.[59] In recent years, foreign lenders and U.S. borrowers have utilized a form of debt security under which the lender may dictate the currency in which repayment is to be made. By way of example, it is argued that characterization of an exchange loss on a loan repayment as a capital loss would be avoided if the loan is repaid in U.S dollars, since repayment with U.S. dollars would not involve a sale or exchange. This view of the law ignores the economic reality that the resulting exchange gain or loss would still be attributable to the value of the foreign currency borrowed, a factor the IRS and the Tax Court would find significant.[60]

Treatment of creditors

If a taxpayer makes a loan of foreign currency and is repaid with appreciated or depreciated currency, the taxpayer will realize exchange gain or loss on the repayment.[61] Under section 1271 of the Code, amounts received by the holder on retirement of a debt instrument are treated as received in a sale or exchange. The character of the gain or loss depends on whether the debt instrument constitutes a capital asset in the hands of the holder.

Accounts payable or receivable

A U.S. taxpayer may agree to make or receive payment in a foreign currency for the sale of goods or the performance of services, thereby creating a foreign currency denominated account payable or account receivable, respectively. Foreign exchange gain or loss will arise if the value of the foreign currency appreciates or depreciates before the account is settled. Under the case law, exchange gain or loss arising from accounts payable or receivable is recognized at the time of payment.[62]

Character.—There should be no legal significance whether foreign currency is borrowed from a third-party or borrowed, in effect,

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[59] Committee on Foreign Activities of U.S. Taxpayers, Section of Taxation, American Bar Association, *Report on the U.S. Treasury Department Discussion Draft on Taxing Foreign Exchange Gains and Losses*, 36 Tax L. Rev. 425, 441 (1981). For a contrary view, *see* Newman, "Tax Consequences of Foreign Currency Transactions: A Look at Current Law and an Analysis of the Treasury Department Discussion Draft," 36 Tax Lawyer 223, 236 (1983).

[60] *See American Air Filter Co.*, 81 T.C. 709 (1983) (where a loan agreement provided that a liability payable in foreign currency could be converted to one payable in another currency, the conversion to a U.S.-dollar liabiiity was treated as a realization event); G.C.M. 39294 (June 15, 1984) (where the IRS noted that repayment in U.S. dollars instead of foreign currency does not alter the tax consequences).

[61] *See KVP Sutherland Paper Co.* v. *United States*, 344 F.2d 377 (Ct. Cl. 1965). In *KVP Sutherland*, the court found three recognition events in a loan transaction: (1) the exchange of foreign currency for a note, (2) the receipt of foreign currency on repayment, and (3) the conversion of the foreign currency received on repayment to U.S. dollars.

[62] *See Bennett's Travel Bureau, Inc.*, 29 T.C. 198 (1956) (where the taxpayer accrued a deduction for accounts payable in Norwegian krone but, in a later year, settled the account at less than the U.S.-dollar amount it had deducted); *Foundation Co.*, 14 T.C. 1333 (1950) (where the taxpayer performed services in Peru and accrued Peruvian soles, and the currency's value at the time of payment was lower than when the income was accrued).

by credit extended by a seller.[63] Consistent with the *Corn Products* doctrine, exchange gain or loss attributable to the settlement of a trade payable or receivable is generally characterized as ordinary income or loss.[64]

Source of exchange gain or loss on accounts payable or receivable.—Applicable rules generally source income from the sale of inventory under the title passage test. Similarly, income from the performance of services is sourced by reference to the place where the services were performed. As noted above, losses are generally apportioned between domestic and foreign sources. In view of the separate transactions principle, however, it appears that exchange gain or loss on settlement of an account relating to the sale of inventory or the performance of services would be sourced under the general sourcing rules discussed above.

Interest on foreign currency denominated debt

Rules of general application.—Normally, a debt instrument is issued at a price approximately equal to the amount that will be received by the lender at maturity, and the return to the lender is entirely in the form of periodic interest payments. In the case of a debt instrument that is issued at a discount, the issue price is less than the amount to be repaid to the lender, and the lender receives some or all of the return in the form of price appreciation. The original issue discount ("OID") is functionally equivalent to an increase in the stated rate of interest, i.e., OID compensates the lender for the use of the borrowed funds. If a debt instrument is issued at a premium, the issue price is more than the amount to be repaid to the lender.

In general, interest is includible in the lender's income (and deductible by the borrower) when paid or accrued. The issuer of an OID instrument is allowed deductions for, and the holder of the instrument is required to include in income, the daily portions of OID determined for each day of the taxable year the instrument is held (secs. 163(e) and 1272). If an instrument is issued at a premium, the premium is treated as income that must be prorated or amortized over the life of the instrument (Treas. reg. sec. 1.61-13(c)). The holder of an instrument issued at a premium can elect to deduct equal annual amounts over the life of the obligation (sec. 171).

Amortization of OID or premium.—The rules for amortizing OID parallel the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds (under the constant yield method).[65]

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[63] *See American-Southeast Asia Co., Inc.*, 26 T.C. 198, 201 (1956) (where the U.S. Tax Court considered this point).

[64] *See Church's English Shoes, Ltd.*, 24 T.C. 56 (1955), *aff'd per curiam*, 229 F.2d 957 (2d Cir. 1956) (where the taxpayer imported goods on credit, the purchase of foreign currency to settle the account payable was viewed as part of the taxpayer's ordinary business, and, thus, an exchange gain was taxable as ordinary income). *See also*, I.R.C. sec. 1221(4) (an account receivable acquired for services rendered or sales of property in the ordinary course of business is excluded from the definition of a capital asset).

[65] Essentially, the borrower is treated as paying the lender the annual interest accruing on the outstanding principal balance, which interest is deductible by the borrower and includible in the income of the lender, and the lender is deemed to lend the same amount back to the borrower. Thereafter, the borrower is deemed to pay interest on the unpaid interest as well as the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the economic accrual of interest or compounding.

OID is allocated over the term of a debt instrument through a series of adjustments to the issue price for each accrual period (generally, each six-month—or shorter—period determined by reference to the date six months before the maturity date). The adjustment to the issue price for each accrual period is determined by multiplying the issue price (as increased by prior adjustments) by the instrument's yield to maturity, and then subtracting the interest actually payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. Although the economic arguments underlying the treatment of OID are equally applicable to premium, taxpayers are not required to use the constant yield method to amortize premium.

Present law does not provide sufficient guidance with respect to the treatment of discount or premium on foreign-currency denominated obligations. For example, it is unclear whether OID is computed by reference to the U.S.-dollar value of a foreign currency at the time an obligation is issued, or the average value in each year that OID accrues.

Measurement of interest income and deductions in deferred payment transactions.—Prior to 1984, the OID provisions did not apply to an obligation issued for nonpublicly traded property where the obligation itself was not publicly traded. The principal reason for this exception was the perceived difficulty in determining the value of nonpublicly traded property, and hence the issue price of (and the amount of OID implicit in) the obligation. Congress addressed this valuation problem by providing objective rules that prescribe an issue price for an obligation issued for nonpublicly traded property (sec. 1274).

Section 1274 performs two roles: (1) testing the adequacy of stated interest, and, where stated interest is inadequate, recharacterizing a portion of the principal amount as interest, and (2) prescribing the issue price. If the prescribed issue price is less than the debt instrument's stated redemption price at maturity, the differential is treated as OID. These calculations are made by reference to the "applicable Federal rate" (generally, the average yield on marketable obligations of the U.S. government with a comparable maturity, referred to as the "AFR").

Under a literal reading of section 1274, an obligation issued for foreign currency is subject to the rules for deferred payment transactions.

Effect of exchange gain or loss on interest denominated in a foreign currency.— Commentators have observed that a loan denominated in a foreign currency may reflect a "true" U.S.-dollar interest rate plus an anticipated annual exchange gain or loss.[66] For example, a U.S. taxpayer who borrows a currency that is viewed as strong in relation to the dollar would pay less interest than if the taxpayer had borrowed dollars (because the lender expects to be repaid with appreciated currency). Conversely, if the taxpayer obtains a loan denominated in the currency of a country experiencing

[66] *See, e.g.*, New York State Bar Association's Ad Hoc Committee on Original Issue Discount and Coupon Stripping, "Preliminary Report on Issues to be Addressed in Regulations and Corrective Legislation," Tax Notes, March 5, 1984, pp. 993–1034.

high rates of inflation, so that the currency is viewed as weak in relation to the dollar, the taxpayer would pay more annual interest than if dollars had been borrowed. In such cases, at least to the extent the parties' expectations prove to be correct, it is arguable that nominal interest is understated or overstated, respectively. This perceived problem exists with respect to foreign currency loans issued at a discount, as well as loans with stated interest.

Thirty-percent withholding.—In certain cases, U.S.-source interest income received by a nonresident foreign person is subject to a flat 30-percent tax on the gross amount paid, subject to reduction in rate or exemption by tax treaties to which the United States is a party (secs. 871(a) and 881).[67] The tax is generally collected by means of withholding by the person making the payment to the foreign recipient (secs. 1441 and 1442). The 30-percent tax is inapplicable if the interest is effectively connected with a U.S. trade or business of the foreign recipient; instead, the income is reported on a U.S. income tax return and taxed at the rates that apply to U.S. persons. The 30-percent tax is inapplicable to interest paid by a U.S. borrower on certain portfolio debt and other investments.

Source of U.S. taxpayer's interest expense.—A U.S. taxpayer's deduction for interest expense is generally allocated between domestic and foreign source gross income in proportion to the borrower's domestic and foreign assets, or, within limits, domestic and foreign source gross income (Treas. reg. sec. 1.861-8(e)(2)).

Hedging transactions

A U.S. taxpayer who has active international operations can "hedge" against changes in the value of (1) foreign-currency denominated assets and liabilities, (2) dividends or royalties receivable from foreign affiliates, or (3) assets of a foreign branch or foreign subsidiary corporation.

Example (2).—In example (1), above, where a U.S. taxpayer borrows 24 million yen when the exchange rate is 240:1, the borrower could hedge against a potential exchange loss (i.e., protect itself against possible appreciation in the value of the yen to be repaid) by entering into a "forward contract" (defined below) to purchase 24 million yen at 240 yen per dollar, for a "premium" (or cost) of, say, $2,000.

If the exchange rate rose to 220:1, the borrower could obtain yen under the forward contract at the lower 240:1 rate, and save $7,080 (the additional $9,080 that would have been required to purchase 24 million yen at the current rate, less the $2,000 premium).

If the exchange rate fell to 260:1, the borrower would still be obligated to purchase yen at the rate specified in the forward contract, although the obligation could be terminated by making a cash payment or entering into an offsetting forward contract.

The U.S. tax consequences of a transaction that is undertaken to hedge foreign exchange exposure turn, in large part, on (1) the nature of the financial product used to effect the hedge, and (2) whether the hedging transaction relates to the taxpayer's own business operations or the business operations of an affiliate. Fur-

[67] The 30-percent withholding tax also applies to other fixed or determinable annual or periodical income from U.S. sources.

ther, different tax rates could apply to the positions included in a hedging transaction, with the result that a transaction that produces no economic gain or loss could result in an after-tax profit or loss.

Description of certain financial products

A taxpayer can fund a foreign-currency denominated asset or liability by purchasing foreign currency at the current exchange rate. The current exchange rate is referred to as the "spot rate." The "spot market" involves trading foreign currency for immediate delivery. A variety of financial products are available for use in reducing the impact of exchange rate fluctuations on foreign-currency denominated assets or liabilities.

Forward contracts.—Trading in foreign currency is conducted in an informal interbank market through negotiated forward contracts. A forward contract calls for delivery or purchase of a specified amount of foreign currency at a future date, with the exchange rate fixed when the contract is made. Forward exchange rates (i.e., premiums or discounts) are determined by reference to interest rate differentials in the interbank deposit market. The currency with the lower interest rate trades at a higher forward price than the spot rate (i.e., at a "forward premium"); the difference between the spot rate and the forward price of the currency trading at a higher interest rate is referred to as a "forward discount."

Example (3) (pricing a forward contract).—Assume that the three-month deposit rate for Deutsche marks is 8 percent compounded annually (for a three-month yield of 2 percent), and the three-month deposit rate for U.S. dollars is 10 percent compounded annually (for a three-month yield of 2 1/2 percent). The spot rate for Deutsche marks is 2.1 (i.e., DM2.1 = $1). If the forward exchange market is perfectly efficient, the forward exchange rate for Deutsche marks should be 2.0898, determined according to a formula:

$$\frac{DM2.1^{1} \times 1.02^{2}}{\$1 \times 1.025^{2}} = 2.0898$$

[1] The spot rate.
[2] One plus the interest rate.

Thus, a taxpayer who requires Deutsche marks in three months time (e.g., to settle an account payable) can either purchase Deutsche marks at the spot rate and deposit them, or enter into a forward purchase contract, and obtain approximately the same results.[68] The taxpayer's choice would be influenced by whether the Deutsche mark is expected to appreciate by an amount that is greater or lesser than the premium.

[68] For a discussion of the foreign exchange market, *see* A. Ruck, "Understanding Foreign Exchange Trading," EUROMONEY p. 117 (April, 1981).

Regulated futures contract.—A futures contract is a standardized forward contract to sell or purchase a specified amount of foreign currency during a designated month in the future. A regulated futures contract ("RFC") is defined for purposes of section 1256 of the Code (discussed below) as a contract that is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading commission (or any board of trade or exchange approved by the Treasury Department), and that is "marked to market" (defined below in the discussion of section 1256 of the Code) under a cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains (as the result of price changes with respect to the contract). The utility of futures contracts as hedging tools is limited, primarily because contracts in excess of 12 months are difficult to obtain.

A variety of foreign currency futures (covering, for example, Deutsche marks, British pounds, and Japanese yen) are traded on the New York Futures Exchange and the International Monetary Market of the Chicago Mercantile Exchange, to name but several exchanges.

Foreign currency options.—A foreign currency option is a contract under which the "writer" grants the "holder" the right to purchase or sell the underlying currency for a specified price during the option period. The consideration (or premium) for option rights is paid at acquisition, and the holder has no further obligations under the option unless or until the option is exercised. Foreign currency options are written by banks, as well as traded publicly on exchanges such as the Chicago Mercantile Exchange and the Philadelphia Stock Exchange.

Example (4).—On the facts of example (2), above, instead of entering into a forward contract, the borrower could acquire an option to purchase 24 million yen at 240 yen per dollar. In such a case, if the yen:dollar exchange rate falls to 260:1, the option could be allowed to expire unexercised, and the 24 million yen could be acquired at the lower current rate.

Parallel loans.—In a parallel (or back-to-back) loan transaction, a U.S. taxpayer lends U.S. dollars to a foreign person, and, contemporaneously, the foreign person lends foreign currency of equal value to the U.S. taxpayer. The terms of the loan agreements are substantially identical, and both loans mature on the same date.[69]

Currency swaps.—Currency swaps were developed as an alternative to parallel loans. A currency swap generally involves an exchange of U.S. dollars for foreign currency at the spot rate, coupled with an agreement to reverse the transaction on a future date at the original exchange rate. A swap can be structured so that there is no actual exchange of currencies; the parties to the swap can simply agree to make payments to each other (i.e., to swap the interest and principal payments).

Interest rate swaps.—In an interest rate swap, the parties agree to make periodic payments to each other, the amounts of which are

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[69] For an extensive discussion of parallel loans, *see* Samuels, "Federal Income Tax Consequences of Back-to-Back Loans and Currency Exchanges," 33 TAX LAWYER 847 (1980).

determined by reference to a prescribed principal amount. Typically, an interest rate swap involves a borrower with access to fixed-rate debt and another borrower with access to floating-rate debt. In a cross-currency interest rate swap, each party pays the other an amount determined by reference to the recipient's interest rate.

Although the swap payments are measured by interest payments, they are not viewed as interest because they are not paid as compensation for the use or forbearance of money. There is a question under present law as to whether swap payments made by a U.S. taxpayer constitute U.S.-source "fixed or determinable annual or periodical income," and, thus, are subject to 30-percent withholding.[70] A related issue is whether an exemption from withholding is available under an income tax treaty to which the United States is a party on the ground that swap payments constitute: (1) "industrial and commercial profits" not attributable to a permanent establishment, or (2) in the case of the U.K. and several other treaties, "other income" that is taxable only by the country of the recipient's domicile. These issues also arise with respect to currency swaps.

Application of provisions relating to tax straddles

Specific statutory rules prevent the use of "straddles" to defer income or to convert ordinary income (or short-term capital gain) to long-term capital gain. In general, a tax straddle is defined as offsetting "positions" with respect to personal property (sec. 1092(c)). The term position is generally defined as an interest (including a futures or forward contract) in personal property of a type that is actively traded. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property.

By their terms, the tax straddle rules apply to most transactions undertaken to hedge foreign exchange exposure, unless the transaction generates only ordinary income or loss (and otherwise satisfies the requirements of the statutory hedging exemption described below).

Loss deferral rule.—If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over any unrecognized gain in offsetting positions (sec. 1092(a)). In addition, taxpayers are required to capitalize otherwise deductible expenditures for property that is part of a straddle, except to the extent of income received with respect to the property (sec. 263(g)).

Taxpayers face uncertainty in determining whether certain hedging transactions constitute straddles. For example, there is a question about whether a currency swap constitutes a straddle if the risk of loss on a foreign currency loan is diminished thereby.[71] If so, the capitalization requirement would apply, and the deduction

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[70] For more detailed information about the business aspects of swaps, *See* J. Price & S. Henderson, *Currency and Interest Rate Swaps* (1984).

[71] *Cf.* I.R.C. sec. 1256(e)(2)(A)(ii) (which extends the hedging exemption to borrowings made or obligations incurred; the implication is that such transactions would be covered otherwise).

of swap payments would be limited to the payments received from the other party to the swap unless the hedging exemption applies.

Mark-to-market rules.—An RFC or a nonequity option that is traded on (or subject to the rules of) a qualified board of trade or exchange (including a foreign currency option) and that is held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Positions that are subject to mark-to-market treatment are referred to as section 1256 contracts. Any gain or loss on a section 1256 contract is generally treated as 40-percent short-term capital gain or loss and 60-percent long-term capital gain or loss. For purposes of these rules, a foreign currency forward contract is treated as a section 1256 contract, if the contract (1) requires delivery of a foreign currency that is also traded as an RFC, (2) is traded in the inter-bank market, and (3) is entered into at an arm's length price determined by reference to the price in the inter-bank market (sec. 1256(g)).

Mixed straddles.—In general, the loss deferral rule applies to a straddle composed of both section 1256 contracts and positions that are not marked-to-market. The section 1256 contracts in a mixed straddle are excluded from the mark-to-market rules if the taxpayer designates the positions as a mixed straddle by the close of the day on which the first section 1256 contract is acquired.

Assume that a foreign-currency denominated loan is offset by a forward purchase contract that is subject to the mark-to-market rule (which could occur if no mixed straddle election were made). Assume further that the taxpayer uses the loan proceeds to make an investment. If the forward contract is marked to market at a loss (because the currency depreciated), the loss would be deferred until the offsetting gain attributable to the loan is recognized. On repayment of the loan, the taxpayer would realize capital gain that is offset by 60/40 loss attributable to the forward contract. Assuming the capital gain is short-term (because the currency was acquired shortly before its use to repay the loan), the 60/40 loss could result in the conversion of unrelated long-term capital gain to short-term capital gain. This would occur because 40 percent of the loss on the forward contract would offset 40 percent of the short-term capital gain, and 60 percent would be applied first to the taxpayer's long-term capital gain from the unrelated transaction, leaving 60 percent of the short-term gain on the loan repayment.

Taxpayers can avoid these results by making a mixed straddle election and foregoing mark-to-market and 60/40 gain treatment. A taxpayer may fail to make a timely election, however, because of uncertainty in determining whether positions in foreign currency are part of a straddle, or because offsetting positions are established inadvertently.

Termination of rights under a forward contract.—Gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property is treated as capital gain or loss, except in the case of the retirement of a debt instrument (sec. 1234A). Property subject to this rule is any personal property of a type that is actively traded and that is (or would be on acquisition) a capital asset in the hands of the taxpayer. Thus, the settlement of a foreign-currency forward contract would

generate capital gain or loss unless the *Corn Products* doctrine applies, regardless of the manner in which the contract is terminated.

Hedging exception.—Certain hedging transactions are exempt from the loss deferral, mark-to-market, and capitalization rules (secs. 1092(e) and 1256(e)). For purposes of this exception, a hedging transaction is generally defined as a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and results only in ordinary income or loss. This hedging exception applies to a transaction that reduces the risk of (1) price change or foreign currency exchange rate fluctuations with respect to property held or to be held by the taxpayer, or (2) interest rate or price changes, or foreign currency exchange rate fluctuations with respect to borrowings or obligations of the taxpayer. For purposes of these rules, a hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Taxpayers face uncertainty in determining whether the hedging exemption applies because of the requirements that the transaction be entered into in the normal course of a trade or business and result only in ordinary income or loss; which requirements implicate the *Corn Products* doctrine. Consider the case of a U.S. corporation that satisfies a need for U.S. dollars by borrowing foreign currency for immediate conversion to U.S. dollars, and then hedges the foreign currency loan (by a currency swap or a forward exchange contract, for example). Assume that the loan proceeds are used for general corporate purposes in the United States. A U.S. corporation might engage in this type of transaction to take advantage of anomalies in foreign capital markets (e g., the willingness of lenders to accept a lower rate of return on loans of certain currencies). The staff understands that taxpayers take the position that the hedging exemption applies to this situation. Apparently, corporate borrowers rely on the case law that supports ordinary income or loss treatment on repayment of a foreign currency loan; however, it is not clear that such transactions are entered into in the normal course of a trade or business.

Related provisions: short sale rules of section 1233.—The Code contains rules that are designed to eliminate specific devices in which short sales could be used to transform short-term capital gain into long-term capital gain, or long-term capital loss into short-term capital loss (sec. 1233(b) and (d)). The rules are stated to apply to stock, securities, and commodity futures, but not to hedging transactions in commodity futures (sec. 1233(e)). Under these rules, if a taxpayer holds property for less than the period required for long-term capital gain treatment, and sells short substantially identical property, any gain on closing the short sale is considered short-term capital gain and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)).

There are several cases that support the position that section 1233(b) is inapplicable to the sale of a foreign currency forward contract.[72] The IRS, however, has taken a contrary view.[73]

Hedges relating to foreign subsidiaries

Under the case law, the *Corn Products* doctrine is applied to hedging transactions only if the hedge relates to the taxpayer's "own" day-to-day business operations. Thus, a hedging transaction with respect to the separate operations of a foreign subsidiary corporation is not treated as falling within the doctrine.[74]

2. Foreign Currency Translation

Under present law, a taxpayer operating abroad is permitted to maintain the books and records of operation in a foreign currency. The method of translating the results of the taxpayer's foreign operation depends on whether the activity is conducted through a branch or through a subsidiary corporation. Additional requirements are imposed if the taxpayer operates through a subsidiary that is a "controlled foreign corporation" (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own 10 percent or more of such stock, referred to as a "CFC").

Present law does not prescribe criteria for use in determining when it is appropriate to record the results of a foreign operation in a foreign currency. Furthermore, for the most part, the method used to translate foreign currency results into U.S. dollars is left to the taxpayer's discretion. The recognized translation methods can produce substantially different U.S. tax consequences.

Branches

A foreign branch that maintains a separate set of books in a foreign currency can use either a "profit and loss" or a "net worth" method to determine U.S. taxable income attributable to the branch operation.[75]

Under the profit and loss method, the net profit computed in the foreign currency is translated into dollars at the exchange rate in effect at the end of the taxable year. If the branch made remittances during the year, these amounts are translated into U.S.-dollars at the exchange rate in effect on the date remitted, and only the balance of the profit, if any, is translated at the year-end exchange rate.

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[72] *American Home Products Co.* v. *United States*, 601 F.2d 540 (Ct. Cl. 1979); *Carborundum Co.*, 74 T.C. 730 (1980).

[73] Technical Advice Memorandum 8016004 (December 18, 1979).

[74] *International Flavors & Fragrances*, 62 T.C. 232 (1974), *rev'd and rem'd*, 524 F.2d 357 (2d Cir. 1975), *on remand*, 36 T.C.M. 260 (1977) (taxpayer sold British pounds short to hedge net asset position of U.K. subsidiary); *The Hoover Co.*, 72 T.C. 206 (1979) (taxpayer entered into forward contracts to offset potential decline in value of stock in a foreign subsidiary), *nonacq.*, 1980-1 C.B. 2 (the nonacquiescence relates to the court's holding that Hoover's sale of a forward purchase contract for foreign currency shortly before the time set for performance—but after the currency was devalued—resulted in long-term capital gain; the IRS's concern was based on the fact that short-term capital gain would have resulted if the taxpayer had accepted delivery under the contract and then exchanged the foreign currency).

[75] *See* Rev. Rul. 75-107, 1975-1 C.B. 32 (relating to the profit and loss method); and Rev. Rul. 75-106, 1975-1 C.B. 31, and Rev. Rul. 75-134, 1975-1 C.B. 33 (relating to the net worth method).

Under the net worth method, U.S. taxable income is defined as the difference between the branch's net worth at the end of the prior taxable year and at the end of the current taxable year. Under this method, the branch's balance sheet is translated into U.S. dollars. In general, the values of current assets and liabilities are translated at the year-end exchange rate, and fixed assets are translated at the exchange rate in effect on the date the asset was acquired (the "historical rate"). The translation of an item at its historical rate defers recognition of exchange gain or loss. Remittances are translated at the exchange rate in effect on the date of remittance, and are then added to the U.S.-dollar amount computed by comparing year-end balance sheets.

The choice of a method for translating the income of a branch is viewed as a method of accounting, and, thus, cannot be changed without the consent of the Secretary.[76] The profit and loss and net worth methods produce different results, primarily because changes in the values of current assets and liabilities are taken into account under the net worth method, but not under the profit and loss method.

Distributions from foreign corporations

A domestic corporation is subject to tax on its worldwide income. Foreign corporations generally are taxed by the United States only on income that is effectively connected with a U.S. trade or business and on certain passive income from U.S. sources. As a result, under the general rules, income derived by a U.S. person through a foreign corporation operating abroad is not subject to tax unless and until the income is distributed to U.S. shareholders. An exception to the general rule of deferral is provided by the subpart F provisions of the Code (secs. 951-964), under which income from certain tax-haven type activities is currently taxed to certain U.S. shareholders of CFCs.

Controlled foreign corporations

The "subpart F" income of a CFC is taxed to "U.S. shareholders" as a constructive dividend, to the extent of post-1962 earnings and profits (secs. 951 and 952(c)). The term "U.S. shareholder" is generally defined as a U.S. person who owns 10 percent or more of a CFC's voting stock (sec. 951(b)). "Subpart F" income generally includes income from (1) related-party sales and services transactions through tax-haven base companies, (2) the insurance of U.S. risks, (3) shipping operations (unless the income is reinvested), (4) oil related activities, and (5) passive investments (sec. 952). A loan with a term of more than one year from a CFC to a related U.S. person is generally treated as an investment in U.S. property (sec. 956), with the result that the amount of the loan is treated as a constructive distribution to U.S. shareholders under the subpart F provisions (sec. 951(a)(1)(B)). A constructive distribution under subpart F includes a pro rata portion of the CFC's exchange gain or loss.

Applicable Treasury regulations provide rules for translating a CFC's earnings and profits and subpart F income (Treas. reg. secs.

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[76] *See American Pad & Textile Co.*, 16 T.C. 1304 (1951), *acq.*, 1951-2 C.B. 1.

1.964-1(a)-(e)). Under the subpart F method of translation, earnings and profits are calculated by computing the sum of the CFC's profit or loss plus the gain or loss determined by translating the CFC's balance sheet (referred to as the "full subpart F method"). The earnings and profits so computed are translated at an "appropriate rate of exchange" (generally, a monthly average of the exchange rates in effect for the taxable year).[77]

Gain from sale or exchange of stock in certain foreign corporations

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. shareholder (as defined above) is recharacterized as dividend income, to the extent of the foreign's corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a CFC (sec. 1248). For purposes of computing the section 1248 constructive dividend, a foreign corporation's earnings and profits are translated into U.S. dollars under the full subpart F method (described above) (Treas. reg. sec. 1.1248-2(d)(2)).

Computation of foreign tax credit

In general, a credit against U.S. tax liability is allowed for foreign income taxes paid or accrued with respect to foreign-source income (sec. 901). As noted in part III, above, the purpose of the foreign tax credit is to mitigate the effects of double taxation of income that is subject to tax by both the United States and a foreign government. The allowable foreign tax credit for a taxable year is limited to U.S. tax liability multiplied by a fraction the numerator of which is foreign-source taxable income and the denominator of which is worldwide taxable income (sec. 904(a)).[78]

For purposes of section 901 of the Code, foreign taxes are deemed paid with respect to dividends received by a U.S. corporation that owns at least 10 percent of the voting stock of the distributing foreign corporation (sec. 902). Similarly, foreign taxes are deemed paid with respect to Subpart F constructive dividends (sec. 960). Thus, these dividends carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

Direct credit

In the case of foreign taxes paid on income derived directly (e.g., through branch operations), taxpayers are generally required to translate the foreign taxes into U.S. dollars at the exchange rate in effect on the date such taxes were paid or accrued.[79] If the amount of foreign taxes accrued differs from the amount paid, or if a foreign tax is refunded (in whole or in part), a taxpayer must notify the IRS, and redetermine the allowable credit for the taxable year

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[77] *See* Treas. reg. sec. 1.964-1(d)(2). If the value of the relevant currency fluctuates substantially during the year, the appropriate rate of exchange might be a weighted monthly average, depending on whether that rate more closely approximates the results of translating individual transactions at the exchange rates in effect when the transactions occurred.

[78] As discussed in part II.B. of this pamphlet, the Administration proposes to replace this overall limitation with a per-country limitation under which the same calculation would be made on a country-by-country basis.

[79] Rev. Rul. 73-491, 1973-2 C.B. 268.

(sec. 905(c)). The rule requiring an adjustment upon the payment of accrued foreign taxes is applied by comparing the U.S.-dollar value of the amount accrued to the U.S.-dollar value of the amount actually paid.[80] Thus, with respect to foreign taxes that are accrued but not paid, subsequent exchange rate fluctuations are taken into account under section 905(c) of the Code.

If a foreign tax is refunded, under the case law, taxpayers are permitted to redetermine the allowable credit by translating the foreign refund into U.S. dollars at the rate of exchange in effect on the date of refund.[81]

Example (5) (refund of foreign tax).—Assume that a taxpayer pays a 10,000 Swiss franc tax when one franc is equal to $.50 (so the U.S.-dollar cost would be $5,000). In a later year, the entire 10,000 franc tax is refunded when one franc is equal to $.40 (so the U.S.-dollar value of the refund is only $4,000). Under the relevant authorities, a $1,000 tax would be eligible for credit even though the foreign tax was refunded.

Indirect credits

To calculate the amount of foreign taxes deemed paid under section 902 of the Code, the amount of foreign taxes paid with respect to the earnings out of which the distribution is made is multiplied by a fraction, the numerator of which is the amount of the dividend and the denominator of which is the amount of the accumulated profits out of which the dividend was paid (referred to as the "section 902 fraction") (sec. 902(a)).

To calculate the amount of foreign taxes deemed paid under section 960 of the Code, foreign taxes paid are multiplied by a fraction, the numerator of which is the Subpart F income and the denominator of which is the CFC's earnings and profits (referred to as the "section 960 fraction").

Actual distributions.—In the case of an actual distribution, the regulations promulgated under section 902 of the Code provide that accumulated profits denominated in a foreign currency are translated into U.S. dollars at the exchange rate in effect on the date the dividend is distributed (Treas. Reg. sec. 1.902-1(g)(1)). At the taxpayer's election, accumulated profits are computed under the profit and loss method prescribed by the regulations promulgated under section 964 (referred to as the "limited subpart F method," because there is no requirement that the balance sheet be translated) (Treas. reg. sec. 1.902-1(g)(2)). In addition, under the long-standing authority of the *Bon Ami Co.* case, the amount of the dividend and the foreign taxes deemed paid are also translated at the exchange rate in effect on the date of distribution.[82] The use of the current exchange rate to translate foreign taxes deemed paid effectively negates section 905(c) of the Code. These rules also apply to

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[80] *First Nat'l City Bank* v. *United States*, 557 F.2d 1379 (Ct. Cl. 1977); *Comprehensive Designers International Ltd.*, 66 T.C. 348 (1976); Rev. Rul. 73-506, 1973-2 C.B. 268.

[81] *American Telephone & Telegraph* v. *United States*, 430 F. Supp. 172 (S.D.N.Y. 1977), *aff'd* 567 F.2d 554 (2d Cir. 1978) Rev. Rul 58-237, 1958-1 C.B. 534.

[82] 39 B.T.A. 825 (1939) (a case decided under the predecessor to section 902 of the Code). *But see American Metal Co.*, 221 F.2d 134, 141 (2d Cir. 1955) (when the foreign corporation keeps its books in U.S. dollars, foreign taxes are translated as of payment date).

constructive dividends under section 1248 (Treas. reg. sec. 1.1248-1(d)(1)).

In the case of a constructive dividend under section 1248, under a literal reading of the applicable regulations, the amount of the dividend in the section 902 fraction is translated under the full subpart F method at an average exchange rate, while accumulated profits and foreign taxes are translated at the exchange rate in effect on the date of the deemed dividend under section 1248.[83]

Example (6).—Assume that a French subsidiary corporation has accumulated profits of 400 French francs before French tax and that a French tax of 100 was paid. Assume further that the profits were earned, and the tax paid, when the French franc was worth $.20. Thus, a French tax with a value of $20 was paid with respect to $80 of income, resulting in an effective tax rate of 25 percent. If the earnings are distributed after the franc's value has fallen to $.10, the parent corporation would be deemed to have paid $10 of French tax (30/30 x $10).[84] If the franc's value rose to $.25, the parent corporation would be deemed to have paid $25 of French tax (75/75 x $25). In either case, the amount of French tax eligible for credit would equal 25 percent of the U.S.-dollar value of the accumulated profits before tax; however, the U.S.-dollar cost of the French tax paid would be understated or overstated, depending on whether the franc's value depreciated or appreciated.

Subpart F constructive dividends.—The full subpart F method is mandated for purposes of computing the deemed-paid credit under section 960 of the Code. Thus, because the balance sheet is translated, exchange gain or loss is taken into account in computing earnings and profits for purposes of the section 960 fraction.

For a CFC that incurs a net exchange loss, the application of the full subpart F method can produce superior results. This is because taking exchange losses into account reduces earnings and profits (the denominator of the section 960 fraction), and thereby increases the allowable deemed-paid foreign tax credit. Under present law, a taxpayer whose CFC has a net exchange loss, but no subpart F income, can effectively elect to use the full subpart F method to increase the deemed-paid credit. This result can be accomplished by repatriating earnings in the form of subpart F income, instead of having the CFC make an actual dividend distribution. Subpart F income can be triggered (and earnings repatriated), for example, by having a CFC make a loan that extends for more than one year to a U.S. shareholder.

3. Related Developments

Financial accounting standards

There was no uniform system of accounting for foreign currency transactions prescribed by the accounting profession prior to the is-

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[83] *But see* G.C.M. 37133, (May 24, 1977) (concluding that accumulated profits should also be determined under the full subpart F method). *See also* D. Ravenscroft, *Taxation and Foreign Currency* 627 (1973) (for an argument that the numerator in the section 902 fraction could be determined under the limited subpart F method, since the full subpart F method of determining earnings and profits is only a limitation on the amount that can be treated as a section 1248 dividend).

[84] As explained more fully in part III.E., above, the after-tax accumulated profits are included in the denominator (300 x $.10 = $30).

suance of Statement of Financial Accounting Standards No. 8 ("FASB 8") by the Financial Accounting Standards Board. FASB 8, which was issued in 1975 effective for fiscal years beginning on or after January 1, 1976, generally required the inclusion of exchange gain or loss in net income for financial reporting purposes.

In 1981, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 52 ("FASB 52"), relating to foreign currency translation, for application to foreign currency transactions and financial statements of foreign entities (including branches and subsidiaries). FASB 52 introduced the "functional currency" approach, under which the currency of the economic environment in which a foreign entity operates generally is used as the unit of measure for exchange gains and losses. Under FASB 52, in most cases, exchange gain or loss is treated as an adjustment to shareholders' equity, and not as an adjustment to net income. In defining a "reporting enterprise," FASB 52 distinguishes a "self-contained" operation from an operation that is an integral extension of a U.S. operation; in the latter case, the indicated functional currency is the U.S. dollar.

1980 Treasury Department Discussion Draft

In December of 1980, the Treasury Department issued a "Discussion Draft" that set forth a comprehensive proposal for the treatment of exchange gain or loss that arises in a business context. The 1980 Discussion Draft adopted an "interest equivalency" approach with respect to assets and liabilities denominated in a foreign currency, under which exchange gain or loss would be treated as an adjustment to interest income or expense, but recognition would be deferred until a transaction was closed out. In addition, a profit and loss method of translation was proposed for all business entities. Finally, on the basis of the Financial Accounting Standards Board exposure draft that became FASB 52, the 1980 Discussion Draft proposed the adoption of the functional currency approach. The 1980 Discussion Draft provided the basis for the Administration's current proposal, and certain of its details will be discussed below.

B. Administration Proposal

The Administration's proposal draws heavily from the Treasury Department's 1980 Discussion Draft: (1) the tax treatment of an exchange gain or loss would turn on the identification of the functional currency of a business entity, (2) exchange gain or loss would be recognized on a transaction-by-transaction basis only in the case of financial assets and liabilities denominated in a currency other than a business entity's functional currency, (3) in the case of foreign-currency denominated financial assets or liabilities, exchange gain or loss would be treated as an increase or decrease in interest income or expense, and (4) exchange gain or loss on certain hedging contracts would be characterized and sourced in a manner that is consistent with the related exposure. The Administration's proposal differs from the 1980 Discussion draft in that taxpayers would be required to accrue currently a portion of the unrealized exchange gain or loss on certain financial assets and liabilities.

As under the 1980 Discussion draft, business entities using a functional currency other than the U.S. dollar would be required to use a profit and loss method of translation at average exchange rates. Similarly, the Administration tentatively proposes to compute a deemed-paid foreign tax credit by using a common exchange rate for translating the amount of dividends, earnings and profits, and foreign taxes deemed paid (the "*Bon Ami*" approach).

1. Functional Currency of a Business Entity

In general, the functional currency of a business entity would be the primary currency of the economic environment in which the entity operates, although a business entity would always be allowed to elect to treat the dollar as its functional currency.

Scope of proposal

Under the Administration's proposal, the tax treatment of exchange gain or loss would turn on the identification of a functional currency. The term "functional currency" would be defined by reference to business activities.

Analysis

Apparently, once a functional currency is identified, the proposed rules would apply to all of an entity's transactions denominated in a foreign currency, including pure investments. On the other hand, it appears that none of the proposed rules would apply to a taxpayer who is not engaged in a business activity, and who enters into a foreign-currency denominated transaction as an investor. The issue presented is whether a broader class of taxpayers should be covered by the Administration's proposal. Although there may be a greater practical need to provide guidance to business taxpayers, there would not appear to be a reason to leave similar issues unresolved in the case of investors.

The 1980 Discussion Draft excluded most investors. Thus, under that proposal, a business entity that entered into an investment transaction would be treated as other investors are treated (except, as discussed below, with respect to stock investments in a CFC). Under the Administration's proposal, there would be a disparity in the treatment between investors that happen to be business entities and other investors.

One objection to extending the proposed rule to all taxpayers is the perceived difficulty in identifying the functional currency of an individual. One option to consider is mandating that individual taxpayers use the U.S. dollar as their functional currency. Alternatively, identification rules similar to those proposed for business entities (described in detail below) could be used. For example, most individuals who reside in the United States transact their affairs in U.S. dollars, and the U.S. dollar would normally be the functional currency. Similarly, a U.S. citizen who resides abroad would presumably identify the currency of the country of residence.

If the scope of the Administration's proposal were expanded to include individual investors, it would be appropriate to consider an exception for transactions that would otherwise fall within the tax straddle provisions.

Definition of "business entity"

Each business of a U.S. taxpayer would have a single functional currency. A "business entity" would be defined as any separate and distinct business operation, the activities of which constitute an active trade or business and are accounted for by a complete and separate set of books and records. Each taxpayer would be treated as a business entity separate from any affiliated taxpayer. A single taxpayer could include more than one business entity. The Administration's proposal indicates that a "business entity" for tax purposes would not necessarily correspond to the definition of a "reporting enterprise" under FASB 52.

Analysis

The 1980 Discussion Draft identified a taxpayer's separate business entities as each "trade or business," within the meaning of section 446(d) of the Code (which permits a taxpayer to use a different method of accounting for each trade or business). The reference to section 446(d) of the Code presented an issue about whether a taxpayer would be viewed as having a separate business entity if that entity was engaged in the same type of activity as the taxpayer. This concern was based on an interpretation that the section 446 regulations would not regard geographical and operational separation as a basis for treatment as a separate trade or business.

Presumably, the Administration's proposal would apply to activities conducted by a corporation, trust or estate, partnership or sole proprietor, as would the 1980 Discussion Draft. The Administration's proposal does not refer to section 446(d). Rather, a business entity is described generally as a "separate and distinct business operation." The staff understands that the Administration's proposal is intended to cover activities that would not be within the definition of section 446(d).

Another option for testing whether an offshore operation constitutes a separate business is provided by the regulations under section 355 of the Code (relating to the tax-free division of corporate activities). Under this standard, a "business" is generally defined as including every operation that forms a part of the process of earning income (Treas. reg. sec. 1.355-1(c); Prop. Treas. reg. sec. 1.355-3(b)(2)(ii)). Thus, functional or vertical divisions would be sanctioned, although an operation with no clients other than the U.S. taxpayer might not pass muster.[85]

Identification of "functional currency"

If a business entity does not elect the U.S. dollar as the functional currency, the functional currency generally would be the currency of the country in which the entity is located and the books and records are kept. Thus, most U.S. taxpayers operating in the United States would use the U.S. dollar as the functional currency.

The identification of a functional currency other than the U.S. dollar would be a question of fact. In making this determination, the following factors would be taken into account: (1) the currency

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[85] *See, e.g., Edmund P. Coady*, 33 T.C. 771 (1960), *aff'd* 289 F.2d 490 (6th Cir. 1961) (where a construction company was divided between two equal shareholders, by the vertical division of major contracts, equipment, and cash).

in which the books of account are maintained, (2) the principal currency in which revenues and expenses are generated, (3) the principal currency in which the entity borrows and lends, and (4) the functional currency of related business entities, and the extent to which the business entity's operations are integrated with those of the related entities. These factors generally correspond to those applicable under FASB 52.

Although the identification of a functional currency would ordinarily require a factual determination, the Administration's proposal indicates that taxpayers would be required to use consistent criteria for identifying the functional currency of entities conducting similar trades or businesses in different countries. If the facts and circumstances did not indicate a particular currency (e.g., where an entity conducts significant business in more than one currency), a taxpayer would have discretion in choosing a functional currency. The choice of a functional currency, including an election to use the U.S. dollar, would be treated as a method of accounting that could be changed only with the consent of the Secretary.

The Administration's proposal indicates that consideration is being given to recommending special rules for business entities operating in a foreign country that is experiencing high inflation rates.

Analysis

The Administration's proposal does not specify what special rules would be required for taxpayers operating in a hyperinflationary economy. One concern may be that, in such a case, the U.S. dollar may be a more appropriate measure of income than the currency of the host country. In this connection, FASB 52 provides that the U.S. dollar is the presumptive functional currency of an entity operating in a highly inflationary economy.

2. Foreign Currency Transactions

The Administration's proposal sets forth rules for the U.S. tax treatment of exchange gain or loss with respect to financial assets or liabilities denominated in a foreign currency other than a business entity's functional currency. Exchange gain or loss would arise if there were a change in the exchange rate between the date the asset or liability is taken into account for tax purposes (i.e., recorded as an item of income or expense, treated as a liability, or assigned an asset basis) and the date it is paid.

Foreign-currency denominated financial asset or liability

A foreign-currency denominated financial asset or liability would be defined as any asset or liability (e.g., trade receivables or payables, preferred stock, and debt instruments), "the principal amount of which is determined in one or more foreign currencies."

Analysis

Under the 1980 Discussion Draft, the term "foreign-currency denominated financial asset or liability" was defined as any asset or liability "the principal amount of which is determined by the value

of one or more foreign currencies." Further, it was explicitly provided that such an asset or liability need not require or even permit repayment with a foreign currency, so long as the principal amount is determined by reference to a foreign currency. Thus, the status of multi-currency compacts was made clear. The Administration's proposal is consistent with the 1980 Discussion Draft to the extent that the economic substance of a financial asset or liability would determine the U.S. tax consequences.

The 1980 Discussion Draft specified that the term "foreign currency" would include not only coin and currency, but also foreign-currency denominated demand deposits and similar instruments issued by a bank or other financial institution.

Current accrual of "anticipated exchange gain or loss"

In the case of a foreign-currency denominated financial asset or liability that provides for a fixed or determinable payment (including an accrued item of income or expense, or an obligation), "anticipated exchange gain or loss" would be recognized on an accrual basis. Both anticipated and unanticipated exchange gain or loss would be treated as an increase or decrease in interest income or expense with respect to a foreign currency denominated asset or liability. The Administration's proposal adopts the interest equivalency approach on the ground that, in most transactions, the parties anticipate that exchange gain or loss with respect to a foreign-currency denominated asset will offset the difference between the yield in the foreign currency and the yield on a comparable U.S. dollar asset over the life of the asset. The stated rationale for requiring current accrual of anticipated exchange gain or loss is to prevent the mismatching that could arise if foreign exchange gain or loss is not taken into account until it is realized. "Unanticipated exchange gain or loss" would be recognized when realized.

In the case of a taxpayer whose functional currency is the U.S.-dollar, "anticipated exchange gain or loss" would be based on the difference between (1) the nominal U.S.-dollar yield on the financial asset or liability, and (2) the AFR with respect to a comparable U.S.-dollar denominated financial asset or liability. The anticipated exchange gain or loss would be equal to the amount that would increase or decrease the nominal yield to the market yield (i.e., the AFR).

If the functional currency is not the U.S.-dollar, the anticipated exchange gain or loss with respect to a currency other than the functional currency would be determined by reference to the market yield on the functional currency. The proposal does not indicate how the market yield on a foreign currency would be determined.

The Administration's proposal indicates that consideration would be given to establishing "safe harbors" for circumstances in which the mismatching of income and expense would not be material.

Analysis

The Administration's proposal is premised on the view that any difference between the yield on a foreign-currency denominated asset or liability and the yield on a comparable U.S.-dollar instrument is attributable to the parties' expectations about future ex-

change gain or loss. Under this theory, for example, if a taxpayer normally borrows U.S. dollars at an interest rate of 10 percent but borrows foreign currency at an interest rate of 25 percent, the taxpayer should be taxed as if exchange gains will reduce the effective cost of borrowing to 10 percent. Consistent with this view, the Administration's proposal would adjust the stated yield on a financial asset or liability up or down, by means of requiring the current accrual of exchange gain or loss that was "anticipated" at the time the transaction was entered into. For purposes of determining what the taxpayer anticipated, reference would be made to the AFR. Essentially, the taxpayer's "true" rate of return or borrowing cost, as the case may be, would be deemed to be equal to the average yield on a marketable obligation of the U.S. Government with a comparable maturity. The Administration's proposal does not specify the manner in which the anticipated exchange gain or loss would be computed and allocated over the term of the financial asset or liability.

Example (7).—Assume that a calendar-year U.S. taxpayer whose functional currency is the U.S. dollar borrows 200 million Italian lira on January 1, 1986. Under the terms of the loan, interest is to be paid at an annual rate of 20 percent and the principal amount is due in three years. The exchange rate on the date of the loan is 1,950 lira per dollar, and the exchange rates on the dates of the three required payments are 2,175 lira per dollar, 2,315 lira per dollar, and 2,620 lira per dollar, respectively. The AFR for an equivalent dollar-denominated note is 10 percent (compounded annually).

Although the proposal may be subject to varying interpretations, under one reasonable interpretation the taxpayer's interest deductions would be limited to $10,256 in 1986, $9,443 in 1987, and $8,659 in 1988, computed as follows:

Year	Dollar value	Interest[1]	Principal repayment (1)–(2)	Principal balance[2]
	(1)	(2)	(3)	(4)
1986	$18,391	$10,256	[3] $8,315	$94,429
1987	17,279	9,443	[3] 7,836	86,593
1988	91,603	8,659	82,944	.....

[1] AFR multiplied by the principal balance of the loan.
[2] Beginning principal balance ($102,564) reduced by amounts treated as repayments of principal.
[3] Anticipated exchange gain.

Thus, under this interpretation of the Administration's proposal, a borrower would be treated as paying interest on the principal balance of the loan (converted at the exchange rate in effect on the date of payment) at a rate equal to the AFR, with any amount in excess of that amount being treated as offset by accrued exchange gain. Moreover, any "unanticipated" exchange gain or loss would be recognized by the taxpayer at the time the loan is repaid. In this example, the taxpayer would recognize an exchange gain of $3,649

in the year of repayment—$86,593, the principal balance of the loan at maturity, minus $82,944, the portion of the final payment deemed to represent a repayment of principal.

Although expectations regarding the future value of a foreign currency are material in setting the stated rate of return on a financial asset or liability, the Administration's proposal recognizes that exchange gain or loss could be more or less than expected. In the case of unanticipated exchange gain or loss, recognition for tax purposes would occur "when realized." The Administration's proposal does not make clear whether the realization event would occur on payment of all or a portion of the principal balance, or at some earlier time (e.g., at the time of a current interest payment). The recognition of unanticipated exchange gain or loss would depend, in large part, on the method used to compute and allocate anticipated exchange gain or loss over the term of the instrument. It is also unclear whether a taxpayer would be required to include amounts in, or permitted to deduct items, from income, solely on the basis of the "anticipated exchange gain or loss" computed initially, without regard to actual exchange rate fluctuations.

Permitting taxpayers to deduct "anticipated exchange losses" that may never materialize could provide a basis for tax shelter transactions. Thus, careful consideration should be given to the method that is used to allocate such amounts. On the other hand, because the right to receive foreign currency does not constitute a right to receive a fixed number of dollars, some would argue that it is unfair to require income inclusions due to exchange gains that could be lost through subsequent exchange rate fluctuations.

In analyzing the 1980 Discussion Draft, several commentators suggested that the interest rate differential should be recognized each year, in order to properly match income and expense. For example, one commentator suggested that the amount that would constitute the premium or discount element in a forward contract had one been obtained could be recognized each year. [86] This approach would involve less complexity than the Administration's proposal.

Character and source of exchange gain or loss

The Administration's proposal provides that, if exchange gains exceed interest expense, the excess of such gains would be treated as additional interest income. If exchange losses exceed interest income, the excess losses would be treated as additional interest expense.

Exchange gains would be sourced under the same rules that apply to interest income. Exchange losses would be allocated and apportioned under the same rules that apply to interest expense.

Analysis

Consideration should be given to whether exchange gain or loss should be treated as interest income or expense for all purposes of the Internal Revenue Code. For example, the 1980 Discussion Draft

[86] Newman at 236.

expressly provided that exchange gain derived by a foreign person would not be subject to the 30-percent withholding tax.

To the extent that the Administration's proposal would allocate a portion of an exchange loss to domestic sources, the proposal could operate to increase the allowable foreign tax credit for the year an exchange loss is recognized. This result would occur to the extent that the denominator of the foreign tax credit limitation (worldwide income) is reduced by an exchange loss, and the numerator thereof (foreign-source taxable income) is not.

Hedging transactions

Special rules would be provided for certain forward exchange contracts that hedge foreign-currency denominated financial assets or liabilities (including an item of income or expense). Essentially, the character and source of an exchange gain or loss on a hedging contract would be the same as those of the item hedged.

For purposes of the special rules, a forward sale contract would be defined as any contract to sell or exchange foreign currency at a future date under terms fixed in the contract, and a forward purchase contract would be defined as any contract to purchase foreign currency with dollars at a future date under terms fixed in the contract. The special rules for hedging transactions would also apply to a contract to exchange foreign currency for another foreign currency at a future date under terms fixed in the contract (which would include parallel loans and currency swaps), and to a contract to receive or pay dollars or a foreign currency (e.g., interest rate swaps).

A contract would be considered to hedge a foreign-currency denominated item if (1) the item would constitute ordinary income or expense to the taxpayer; (2) the primary purpose of the contract (either alone or in combination with other contracts) is to offset the impact of a change in the exchange rate on the U.S.-dollar value of the item, and (3) either the taxpayer identifies the contract as hedging a particular item, or the Commissioner determines that, under the facts and circumstances, the contract hedges a particular item. The term "hedge" would be defined to exclude a contract that offsets the risk of exchange rate fluctuations with respect to the value of stock in, assets held by, or liabilities of a subsidiary corporation.

The exchange gain or loss on a forward sale contract that hedges the principal amount of a foreign-currency denominated financial asset would be recognized on an accrual basis, and treated as an increase or decrease in the interest received with respect to the asset. The exchange gain or loss on a forward purchase contract that hedges the principal amount of a foreign-currency denominated financial liability would be characterized and sourced in the same manner as interest paid with respect to the liability. The exchange gain or loss on a forward sale or purchase contract that hedges an item of interest or expense would be characterized and sourced in the same manner as an increase or decrease in the item. The Administration's proposal indicates that comparable rules would apply to contracts for payments made to offset foreign exchange fluctuations.

Analysis

The scope of the Administration's proposal for hedging transactions is not as broad as that of the 1980 Discussion Draft. One difference is the treatment of a hedge relating to stock in a CFC. Under the 1980 Discussion Draft, exchange gain or loss on a hedging transaction relating to stock in a CFC would be treated as ordinary and domestic source. It may be appropriate to consider the question of whether a U.S. corporation hedging the foreign currency exposure of a CFC should be viewed as hedging its own future receipt of ordinary income (under subpart F or, on disposition of stock in the CFC, section 1248 of the Code).

The 1980 Discussion Draft also provided rules for the treatment of exchange gain or loss arising on a contract that hedges a foreign income tax liability or anticipated refund. Under the 1980 Discussion Draft, if a taxpayer established that a contract was specifically hedging a foreign income tax liability, exchange gain or loss on the contract would be treated as an adjustment to the amount of foreign tax available for credit. The staff understands that a similar rule is intended to apply under the Administration's hedging proposal.

Regarding the character of exchange gain or loss on forward exchange contracts, some argue that the characterization as increases or decreases in interest income or expense should be limited to the premium or discount element of a contract used to hedge. The argument made is that, while the premium or discount serves to adjust for interest rate differentials, the exchange gain or loss on settlement of the contract may be caused by factors other than changes in interest rates.

3. Foreign Currency Translation

Mandatory profit and loss method

A business entity that uses a functional currency other than the U.S. dollar would be required to use a profit and loss method to translate income or loss into U.S. dollars, at the average exchange rate for the taxable year. The average exchange rate for a period would be the rate that would produce approximately the same U.S.-dollar amount if each gross receipt were recorded at the exchange rate in effect when taken into account for tax purposes. A taxpayer would be permitted to use any reasonable procedure, consistently applied, to determine an appropriately weighted exchange rate for the period.

The Administration's proposal recognizes that the use of a net worth method of translation by foreign branches generally accelerates the recognition of exchange gain or loss before any realization event, and the full subpart F method produces a similar result for CFCs. Also, a concern is expressed about the implicit election enjoyed by CFCs to recognize net exchange losses, and thereby distort the calculation of the deemed-paid foreign tax credit.

Analysis

Commentators argue that the electivity achieved by deciding when to trigger subpart F income could be addressed by requiring

an irrevocable election to use a profit and loss method *or* a net worth method. In considering this option, it should be noted that exchange rate fluctuations with respect to certain currencies are predictable to some extent (e.g., the continuing depreciation of the Brazilian cruzeiro). Thus, a taxpayer would almost always elect the net worth method for operations in a country with a weak currency (to accelerate losses) and the profit and loss method for operations in a country with a strong currency (to defer gain).

A profit and loss method can be viewed as being more consistent with the functional currency concept than a net worth method. Under a profit and loss method, the functional currency is used as the measure of income or loss, so that earnings determined for U.S. tax purposes would bear a close relation to taxable income computed by the foreign jurisdiction. In contrast, a net worth method would take unrealized exchange gains and losses into account. Further, a profit and loss method would minimize the accounting procedures that otherwise would be required to make the item-by-item translations under a net worth method.

Finally, in the case of a branch, the net worth method fails to accurately characterize items of income or loss that are subject to special U.S. tax rules. For example, although there are limitations on the deductibility of long-term capital losses, such a loss incurred by a branch would be given tax effect because it would be reflected as an adjustment to the balance sheet.

Treatment of branch remittances

Solely for purposes of recognizing exchange gain or loss on remittances from a foreign branch, a taxpayer that uses the U.S. dollar as its functional currency would be considered to have a U.S.-dollar "basis" in the foreign branch. The taxpayer's deemed basis would be increased by contributed property (translated on the date of contribution) and unremitted earnings (translated at the average exchange rate for the taxable year in which earned). Losses (translated at the average exchange rate for the year incurred) and remittances (translated at the exchange rate on the date remitted) would reduce the taxpayer's deemed basis. Exchange gain or loss on remittances would be recognized only after the deemed basis is recovered, in a manner that is analogous to the treatment of cash distributions from a partnership. These rules are intended "to ensure that the cumulative gain or loss recognized over the life of a branch is the same, without regard to its functional currency."

Analysis

The proposed treatment of losses and remittances addresses the issue of how amounts remitted by a branch to its home office should be allocated among unremitted branch earnings from prior years and contributions to branch capital, when such remittances exceed the branch's current income. Because the profit and loss method proposed by the Administration would not translate balance sheet gains and losses, some mechanism for recognizing gains and losses inherent in functional currency or other property remitted to the home office must be provided. The Administration's proposal would permit taxpayers to defer recognition of such amounts until the "deemed basis" has been fully recovered.

An alternative approach would be to assume that reittances in excess of current profits are first made out of unremitted branch profits from prior years, perhaps allocating on a last-in-first-out ("LIFO") basis. After all reinvested profits of the branch had been exhausted, capital contributions to the branch could then be recovered. Although this approach would be more consistent with the treatment of distributions from foreign subsidiaries and may more accurately reflect the economic income of the taxpayer, it may be more complicated and difficult to apply than the Administration's proposal.

Calculation of direct foreign tax credit

The Administration's proposal indicates that the amount of foreign income taxes claimed as a credit would be restated to take account of any refund or difference between the amount accrued and the amount paid. The restated foreign tax would be translated at the exchange rate in effect when the tax was originally taken into account for Federal income tax purposes.

Analysis

Under the 1980 Discussion Draft, exchange rate fluctuations between the date foreign taxes were originally paid or accrued and the date of a refund or other adjustment would be accounted for by reference to the exchange rate in effect on the date of the refund or other adjustment (as under present law). This approach was criticized because it would measure the redetermined foreign tax credit by taking into account exchange rate fluctuations occurring after the foreign tax was paid. On the other hand, the Administration's proposal to determine the adjustment as of the original payment date is inconsistent with the view that the function of the foreign tax credit is to allow the U.S.-dollar cost of a creditable foreign tax as an offset against U.S. tax liability.[87]

Calculation of indirect foreign tax credit

The Administration "tentatively" proposes that the *Bon Ami* approach be followed. Accordingly, a common exchange rate would be used to translate the amount of an actual or constructive distribution, the pool of earnings and profits from which the distribution derives, and the foreign taxes deemed paid with respect to such earnings.

In the case of an actual distribution, the exchange rate for the date of distribution would be used. With respect to amounts deemed distributed under subpart F, the pool of earnings and the deemed-paid taxes would be translated at the average exchange rate for the year in which the subpart F income is earned.

Earnings previously taxed under subpart F would be segregated in a separate pool. If previously taxed income were distributed, any incremental exchange gain or loss on the actual distribution would be treated as ordinary and domestic source income or loss. The exchange gain or loss on the subsequent distribution would be measured by multiplying (1) the amount of the distribution, in terms of

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[87] For an argument in favor of converting the amount of a tax refund as of the date of refund, *see* E. Owens, *The Foreign Tax Credit* 462 (1961).

the foreign currency, by (2) the difference between the exchange rate for the date of the deemed distribution and the exchange rate on the date of the actual distribution.

The Administration's proposal recognizes that the *Bon Ami* approach has significant defects: (1) the exchange rate gain or loss between the date income is earned and the date it is paid is, in effect, characterized as an increase or decrease in earnings and profits, and (2) the deemed-paid foreign tax is also increased or decreased by exchange rate fluctuations, even though the tax may actually have been paid in an earlier year (so that the tax liability in terms of U.S. dollars was fixed). The Administration's proposal also indicates a concern about the continued use of a "date of distribution" exchange rate for actual dividends and an "average" exchange rate for subpart F constructive dividends.

Analysis

The *Bon Ami* approach is often defended on the ground that it preserves the historic ratio between foreign taxes and accumulated profits, so that the U.S. dollar value of the foreign tax eligible for credit is the same percentage of the U.S.-dollar value of the dividend as the foreign-currency denominated tax was of the related earnings. On the other hand, it is not clear that retention of the foreign tax rate should be a goal of U.S. tax policy. Although the 1980 Discussion Draft adopted the *Bon Ami* approach, it was noted that this approach results in a tax advantage if the foreign corporation's functional currency appreciates against the dollar, and a tax penalty if the functional currency depreciates in value. The Administration's proposal echoes this concern.

Some argue that, if exchange gain is not taxed in a foreign jurisdiction, then such amounts should not enable taxpayers to absorb excess foreign tax credits. Critics of the *Bon Ami* approach point out that once a subsidiary actually pays a foreign tax, the U.S.-dollar cost is fixed, and thus it is inappropriate to measure the tax liability by the exchange rate at any other time. It is also pointed out that the *Bon Ami* approach is inconsistent with the rules applied to taxpayers who are eligible for the direct foreign tax credit (because they operate through branches). This inconsistency is somewhat ironic, since the purpose of the indirect tax credit is to equalize the tax burden on domestic corporations operating abroad through subsidiaries with the tax burden on domestic corporations operating abroad directly (through branches). Finally, it is argued that a corporation operating through a subsidiary always has the option to maintain the desired "historic" relationship between foreign taxes and accumulated profits by repatriating earnings on a current basis. Thus, it is asserted that foreign taxes should be translated at the historical rate, and exchange gain or loss should not be characterized as an increase or decrease in earnings and profits.

Previously taxed income.—Under the 1980 Discussion Draft, the foreign source of exchange gain or loss on distributions of previously taxed income would be preserved.

Miscellaneous issues

The Administration's proposal does not address several other issues that were treated by the 1980 Discussion draft: (1) subject to an identification requirement, taxpayers were given an election to accrue gains and losses on transactions or "working balances" of foreign currency; current market valuation would be limited to balances held for use in a trade or business; and (2) rules were provided for the treatment of U.S. branches of foreign persons (addressing issues such as whether exchange gain or loss on remittances would be treated as effectively connected with a U.S. trade or business).

Effective dates

In general, the proposals relating to the taxation of exchange gains and losses would be effective as of January 1, 1986. The proposed rules for foreign currency denominated financial assets and liabilities would be effective for items acquired or incurred after January 1, 1986.

VI. FOREIGN TAXPAYERS

A. In General

Present Law and Background

The United States taxes the worldwide income of U.S. citizens, residents, and corporations on a net basis at graduated rates. The United States generally taxes the U.S. income of nonresident aliens and foreign corporations that is "effectively connected" with a U.S. trade or business on a net basis, in the same manner, and at the same rates, as the U.S. income of U.S. persons. Some foreign income of a foreign taxpayer from a U.S. business also is taxed by the United States on a net basis. Foreign income of a foreign taxpayer that is not connected with a U.S. business of the taxpayer is generally not taken into account in determining the rates of U.S. tax applicable to the income of the taxpayer from a U.S. business.

U.S. income of a foreign taxpayer that is not connected with a U.S. trade or business generally is subject to a different tax regime. A foreign individual or corporation is ordinarily subject to a 30-percent withholding tax on the *gross* amount of certain passive income, such as rents, dividends, and some interest, that is received from U.S. sources and is not connected with a U.S. trade or business. In most instances, the amount withheld is the final tax liability of the foreign taxpayer and thus that taxpayer files no U.S. tax return with respect to this income.

Some bilateral U.S. income tax treaties reciprocally reduce the United States' 30-percent tax, and any gross withholding tax otherwise imposed by the treaty partner, on dividends, interest, and royalties. In addition, the Code unilaterally provides some exemptions from the 30-percent tax, both directly and by the treatment of certain income as foreign income rather than U.S. income. For example, interest from deposits with persons carrying on the banking business and similar institutions is foreign income under present law and is therefore exempt.[88] Original issue discount on obligations maturing in six months or less is exempt. The Tax Reform Act of 1984 exempted from the 30-percent tax certain interest paid on portfolio obligations issued after July 18, 1984 (the 1984 Act's date of enactment).

The United States generally does not tax capital gains of a foreign corporation that are not connected with a U.S. trade or business. Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are taxed only if the individual was in the United States for 183 days or more during the

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[88] The Administration has proposed that such income be treated as U.S. income and exempted directly from the 30-percent withholding tax. (*See* discussion of income sourcing rules in Part III. C., above.)

year. Such gains generally are taxed at a flat rate of 30 percent. Under the Foreign Investment in Real Property Tax Act of 1980, gains of a foreign individual or corporation on the disposition of U.S. real property interests are taxed on a net basis, even if they are not otherwise effectively connected with a U.S. trade or business.

Proposal

H.R. 2763 (Duncan) and S. 758 (Wallop) would repeal the tax on foreign sellers of U.S. real property interests (repeal FIRPTA).

Analysis [89]

Opponents of FIRPTA argue that its repeal would encourage foreign capital to flow to the United States. They argue that foreign investors may shun purchases of U.S. real property, because they might have to pay U.S. tax on eventual disposition. They contend that the tax is difficult to collect. Some argue that some of the concerns that led to FIRPTA's enactment no longer exist. In particular, they contend, a concern that foreign investors were bidding farm prices too high has been replaced by a concern that farm prices may be too low. The question the advisability of taxing real estate gains, but not other capital gains.

Advocates of the retention of FIRPTA argue that foreigners should pay tax on sales of U.S. real property. They contend that tax law should not favor foreigners over Americans, and that repeal would create tax incentives for foreigners to own American land. They argue that FIRPTA generally does not keep foreign investors from investing in U.S. real property, because eventual U.S. tax is generally only a minor consideration to those investors. They argue that withholding on foreign sellers of U.S. real property, which Congress enacted in 1984, makes collection of the tax feasible. They note that repeal would reduce tax revenues somewhat.

B. Interest Expense Allocation

Present Law and Background

When foreign taxpayers earn income that the United States taxes on a net basis (on the ground that it is effectively connected with a U.S. trade or business), they, like U.S. taxpayers, deduct interest expense from their gross income. The Code allows the deduction of expenses that are connected with effectively connected income, but delegates to the Secretary of the Treasury the determination of what expenses are connected with what income. Treasury regulations allow foreign taxpayers to use either of two special methods of determining whether interest expense offsets taxable (effectively connected) income or nontaxable income. The two methods that foreign taxpayers may use differ distinctly from the pro rata allocation on the basis of assets (or sometimes gross income) that U.S. taxpayers must use in calculating the foreign tax

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[89] For detailed discussion of the issues that FIRPTA presents, see Joint Committee on Taxation, *Description of S. 1915, Relating to Tax Treatment of Foreign Investment in U.S. Real Property* (JCS-25-84), June 18, 1984.

credit limitation (the rules for U.S. taxpayers are discussed above in connection with the foreign tax credit limitation).

In determining the interest expense that foreign taxpayers may deduct to ascertain net effectively connected income, the current Treasury regulations (under section 882) first seek to prevent taxpayers from overstating their debt-equity ratios. The regulations do so by allowing deductions only with respect to "allowable" U.S.-connected liabilities, which is assets that generate effectively connected income multiplied by a percentage. The percentage is either (1) the taxpayer's actual worldwide ratio of liabilities to assets, or (2) a fixed amount (95 percent for financial institutions like banks, 50 percent for other corporations).

Having arrived at "allowable" liabilities, the regulations allow taxpayers a choice of methods to compute interest expense. Under one method, the "branch book/dollar pool" method, taxpayers compare book liabilities to allowable liabilities. If allowable liabilities are greater, the taxpayer deducts booked interest paid to third parties plus the product of the taxpayer's average interest expense incurred for U.S. dollars outside the United States and the excess allowable liabilities. If book liabilities are greater, the taxpayer deducts the product of allowable liabilities and the average interest expense rate on the U.S. books. Under the other method, the "separate currency pool" method, in general, the taxpayer first determines, for each currency, the ratio of allowable of allowable U.S.-connected liabilities in that currency to total U.S. book liabilities in all currencies. The taxpayer then multiplies that ratio by the product of total U.S. book liabilities in that currency and the average interest rate that the taxpayer paid on worldwide liabilities in that currency. The total interest deduction under the separate currency pool method is the sum of the interest deductions, calculated in this way, for all currencies.

Possible Proposals

1. Make foreign taxpayers and U.S. taxpayers allocate and apportion interest expense in the same way.
2. Eliminate one of the options that foreign taxpayers now have for the calculation of interest expense.

Analysis

The interest expense allocation rules for U.S. taxpayers presuppose that money is fungible: that each dollar of interest expense allows a taxpayer to hold a pro rata portion of all the taxpayer's assets (or to earn, in some cases, a pro rata portion of all the taxpayer's gross income). The rules for foreign taxpayers, embodied in Regulations under Code section 882, in general, do not follow this presupposition.

There appear to be two reasons for treating foreign taxpayers and U.S. taxpayers differently. First, the United States has jurisdiction over and information about the worldwide income of U.S. taxpayers. The United States cannot so easily get information about the foreign activities of foreign taxpayers. As a practical matter, U.S. activities of foreign taxpayers may sometimes be so minor as not to warrant the burden and the intrusion of the full

analysis that a perfect expense allocation system would require. However, each of the two methods that foreign taxpayers may choose to calculate deductible interest expense can require examination of some of the foreign taxpayers' foreign activities. Second, foreign taxpayers typically incur large amounts of interest expense in currencies other than the dollar. Foreign currency borrowings typically result in nominal interest expense that is different from the interest expense that would result from a similar dollar loan. That nominal interest expense, if allocated against gross effectively connected income, would often result in an inappropriate amount of net effectively connected income. If Congress adopts rules to deal with foreign currency for U.S. taxpayers, however, those rules might be appropriate for foreign taxpayers as well. If so, the rules governing interest expense allocation for U.S. taxpayers might be appropriate for foreign taxpayers.

Some foreign taxpayers now argue, however, that income tax treaties require the United States to compute branch expenses on a separate entity basis, without considering the home office. The United States rejects this argument. Adoption of the U.S.-taxpayer method for foreign taxpayers would move away from a separate entity method, so foreign taxpayers' complaints might intensify.

If the interest expense rules that U.S. taxpayers use are not appropriate for foreign taxpayers, then the rules that foreign taxpayers use may be appropriate for U.S. taxpayers. However, proponents of fungibility argue that money is fungible and that interest expense is attributable to all activities and property of the payor regardless of any specific purpose for incurring an obligation on which interest is paid. They note that application of the fungibility concept prevents manipulation of the interest deduction. They argue that the inability of foreign taxpayers to allocate interest expense correctly is not a valid reason to abandon fungibility for U.S. taxpayers.

In one respect, however, current law tends to allow some comparably situated taxpayers to use that set of rules that results in the least U.S. tax. In general, banks obtain low-cost funds in their home countries (*e.g.*, through interest-free checking accounts). If U.S. banks obtain funds for loans to U.S. borrowers more cheaply than they obtain funds for loans to foreigners, the fungibility approach provides more foreign source income than does a tracing approach. This increase in foreign source income increases the banks' foreign tax credit limitation and may reduce their U.S. tax liability. By contrast, if foreign banks obtain funds for loans to home country borrowers more cheaply than they obtain funds for loans to U.S. borrowers, the section 882 Regulation's diversion from the fungibility approach for these taxpayers provides less effectively connected income and, thus, less U.S. tax.

Each of the section 882 Regulation's optional methods appears to allow unduly generous treatment in some cases. The branch book/dollar pool method sometimes allows taxpayers to use a dollar interest rate even when the branch conducts some of its U.S. operations in foreign currency. This may allow too great an interest deduction for the branch. The separate currency pools method may allow taxpayers to create unduly high interest expense by borrowing in weak currencies at high nominal interest rates. In any

event, it is not clear why foreign taxpayers should be able to choose between two methods.

C. U.S. Corporations that Belong to Foreign Persons

Present Law and Background

In theory, U.S. tax law does not distinguish between U.S. corporations on the basis of ownership. That is, a U.S. corporation pays the same U.S. income tax whether its owners are Americans or foreign persons.

In practice, however, a U.S. corporation that belongs to foreign owners may deduct tax-free payments to them. In particular, a foreign-owned U.S. corporation may be able to reduce its U.S. taxable income by making interest or royalty payments to related foreign persons. The payor can normally deduct those payments from U.S. taxable income. (In 1984, Congress prohibited the accrual of interest deductions on obligations to related foreign parties until actual payment.) A U.S. income tax treaty (with the recipient's home country) may limit or even prohibit U.S. taxation of those payments in the hands of the recipient. That is, these payments are deductible, but not includible, for U.S. income tax purposes. (Similar payments by a foreign corporation that operates in the United States also may be deductible.) The home country of the recipient may or may not collect tax on those payments. Foreign tax credits or other devices may eliminate the foreign tax on the interest or royalty payments out of the United States.

A U.S.-owned U.S. corporation, by contrast, generally cannot pay tax-free interest or royalties to its owners. The paying corporation can generally deduct the interest it pays its U.S. owners, but those recipients must include the interest in taxable income.

In 1969, Congress told the Treasury to prescribe regulations to determine whether an interest in a corporation is stock or indebtedness for tax purposes. The Treasury has never issued these regulations in final form. Today, the determination of a corporation's debt-equity ratio takes place on a case-by-case basis.

Possible Proposal

A possible proposal would be to limit the deduction for interest payments to foreign owners of U.S. corporations. To accomplish this goal, some debt issued to foreign stockholders could be treated as stock if that debt is too great in proportion to equity. For example, some of the deduction for interest paid to a related foreign person could be disallowed if the ratio of debt held by foreign stockholders to their equity exceeds 1 to 1 or some other ratio.

Analysis

Imposing a debt-equity ratio for foreign-owned U.S. taxpayers would limit the "stripping" of earnings as deductible debt. It would reduce the substantial tax incentive that present law provides for treaty-country owners of U.S. corporations to capitalize those corporations with debt rather than equity. Unless the rule applied to U.S.-owned corporations, however, it might violate U.S. obligations under treaties. Moreover, it might cause foreign persons who own

or who contemplate buying U.S. corporations to seek other investments.

Some other countries use formulas to deny deductions for certain interest paid to foreign owners of local corporations. Canada, for example, imposes a 3 to 1 debt-equity ratio on payments to foreign stockholders. France imposes a 1.5 to 1 debt-equity ratio on payments to any stockholders, whether French or foreign. Other countries, like the United States, have avoided use of a formula.

The inability of the Treasury Department and the IRS to issue regulations to distinguish between debt and equity generally under Code section 385 may indicate that a statutory debt-equity ratio is not wise. The alternative to a formula, however, is a case-by-case approach, which allows uncertainty and possible manipulation.

D. Branch-Level Tax

Present Law and Background

In general, the United States seeks to tax foreign corporations that operate in the United States like U.S. corporations that operate here. This goal of symmetrical treatment extends to dividend and interest payments, that is, the United States seeks to tax dividends and interest paid by foreign corporations that operate in the United States like dividends and interest paid by U.S. corporations that operate here. If the recipient of the dividends or interest is a U.S. person, the United States imposes tax on the dividends or interest at the regular graduated rates. If the recipient of the dividends or interest is a foreign person, however, symmetry is more difficult to enforce.

A U.S. corporation that pays dividends to a foreign person generally must withhold 30 percent of the payment as a tax. The United States imposes the tax at a flat 30-percent rate because it is generally not feasible to collect a net-basis graduated tax from foreign persons who may have very limited tax contacts with the United States. Similarly, a 30-percent withholding tax applies to some interest paid to foreign persons, including interest paid to related parties and to certain interest paid to banks. Some interest paid to foreign persons is exempt from U.S. tax, however. Some U.S. income tax treaties eliminate the tax on all interest and reduce the tax on dividends to as little as five percent.

Similarly, a foreign corporation that has enough U.S. activity and that pays dividends (or some kinds of interest) to a foreign person must withhold a portion of the payment as a tax. A foreign corporation becomes liable to withhold when more than half of its gross income for a three-year period is effectively connected with a U.S. trade or business. If it crosses that 50-percent threshold, the 30-percent (or lower treaty rate) tax applies to a fraction of the payment. That fraction is effectively connected income divided by worldwide income. One purpose of this withholding tax is to treat payments by foreign corporations with U.S. operations like payments by U.S. corporations.

Administration Proposal

The Administration proposal would repeal the withholding taxes on dividends and interest paid by foreign corporations with U.S. operations, and would replace the tax on dividends with a tax on branch profits. For this purpose, branch profits would consist of distributable profits after allowing for reinvestments and for U.S. income taxes paid by the foreign corporation. The proposal would replace the tax on certain interest with a tax on interest payments by foreign corporations to foreign persons that corresponds to the U.S. tax on interest payments by U.S. persons to foreign persons. The tax on interest payments would apply to interest allocable to the branch, and the allocable interest would be part of the base of the branch-level tax. Also, the proposal would fix the rate of the tax at 30 percent, but if the recipient resides in a treaty country, it would reduce the rate to the rate that applies to direct investment dividends under the treaty.

When a treaty prevents U.S. imposition of the proposed tax, the proposal would have the Treasury Department seek to renegotiate the treaty.

Other Possible Proposal

An additional possible proposal would be to limit the deduction for interest payments to foreign owners of foreign corporations that are taxable in the United States. To accomplish this goal, some debt issued to foreign stockholders could be treated as stock if that debt is too great in proportion to equity. For example, some of the deduction for interest paid to a related foreign person could be disallowed if the ratio of debt held by foreign stockholders to their equity exceeds 1 to 1 or some other ratio.

Analysis

The Administration argues that the proposed system of branch level taxes would rationalize the taxation of foreign corporations operating in the United States and their shareholders. Under present law, a foreign corporation with large U.S. operations can avoid any U.S. tax beyond the corporate level, that is, it can avoid any shareholder-level tax, if its non-U.S. operations are large enough. These rules tend to favor branch operations in the United States over subsidiary operations in the United States. Also, the present system is hard to enforce, because U.S. taxation turns on an analysis of the worldwide operations of foreign corporations. Moreover, it may be difficult for the United States now to collect the tax even if it is due.

Although a branch-level tax might technically violate some U.S. treaties, it would not actually discriminate against U.S. operations of foreign corporations. The United States attempts to tax corporate profits at two levels, the corporate level and the shareholder level. Some treaties promise that the United States will not collect more corporate-level tax from a foreign branch than it collects from a similar U.S. corporation. In the case of a U.S. corporation, the United States collects a shareholder-level tax on its dividend payments. In the case of a foreign corporation with U.S. operations,

the United States may not. The Administration proposal for a branch-level tax would compensate for the lack of a shareholder-level tax by adding to the corporate-level tax. Unless the treaty partner country is failing to collect a branch-level tax of its own because of the treaty, and unless the treaty also prevents imposition of the withholding taxes that the Administration would repeal, it is not apparent why Congress should not override the treaty.

Treaties, however, provide significant benefits to the United States and to U.S. taxpayers. (*See* generally Part VII., below.) Treaties reduce foreign taxes that U.S. taxpayers pay. These reductions sometimes benefit the taxpayer; sometimes they benefit the Treasury, because they reduce foreign tax credits and thus increase U.S. tax. Unilaterally overriding treaty provisions might prompt other countries to violate their obligations to the United States and to U.S. taxpayers. Selective retaliation might harm U.S. interests.

If the Administration proposal does not override treaties, it may be unrealistic to assume that foreign countries will renegotiate treaties to allow the branch-level tax without insisting on substantial U.S. concessions on other issues. Many treaties allow branch-level taxes, however, so renegotiation could prove feasible. Even if the effort to renegotiate treaties is largely successful, foreign persons may try "treaty shopping", that is, the use of a conduit entity in a treaty country that is not their home country, unless the United States renegotiates all treaties that lend themselves to abuse in this way, or otherwise stops treaty shopping. (Treaty shopping is discussed further in Part VII. below.) Therefore, the proposal arguably should override treaties. In any event, since some treaties now allow the United States to impose its withholding taxes on dividends and interest paid by foreign corporations, if Congress decides not to override treaties, it may be advisable to retain, not repeal, those withholding taxes so long as treaties prevent a branch-level tax from replacing them. These taxes now raise very little revenue, however.

Opponents of the Administration proposal argue that it is inappropriate to analogize to U.S. subsidiaries for one purpose, the branch-level tax, but not for other purposes, such as interest expense allocation and branch-home office transactions. They contend that a branch-level tax would discriminate against foreign business (by subjecting foreign branches to an additional tax that does not apply directly to U.S. businesses). They also argue that the proposed taxes would be very complex to calculate. They assert, in particular, that it would be difficult to determine deductible reinvestment, especially for banks, and that the allocation of interest expense would be difficult. In addition, to the extent that U.S. tax on interest payments by a foreign corporation is due (because, e.g., the recipient is a related party without treaty protection) it is not clear that the proposed tax would be much easier to collect than the current tax.

Applying the branch-level tax to related-party interest and certain other interest at the rate applicable to treaty-protected direct investment dividends arguably would create anomalies: for instance, interest paid by a U.S. corporation to its U.K. shareholder would be tax-exempt, while interest that a British corporation pays to its British shareholder, if attributable to the British corpora-

tion's U.S. branch, would incur U.S. tax. Application of the dividend rate treats the interest that is taxable under the branch-level tax as part of the base of the tax. This treatment makes the tax uniform and limits the benefits of debt capitalization by shareholders. There would still be a strong incentive for foreign shareholders to lend money (rather than contribute capital) to their corporations with U.S. operations, however. U.S. treaties typically reduce the rate on direct dividends to between five and 15 percent, so the branch would obtain a deduction from taxable income that enables it to reduce tax by 33 percent of the amount paid (under the proposed rate reduction) while the inclusion would be substantially less than the deducted amount. The possible proposal to impose a debt-equity standard on interest deductions of foreign corporations with U.S. operations would limit this incentive. (See discussion in Part VI. C., above.)

VII. INCOME TAX TREATIES

Present Law and Background

The United States has entered into more than 30 bilateral income tax treaties. These treaties have two purposes. One is prevention of double taxation, that is, the treaties prevent one signatory from fully taxing income that the other signatory taxes. The other is prevention of tax evasion.

Under the U.S. Constitution, treaties have the same effect as Acts of Congress. Like Acts of Congress, treaties are subject to Constitutional requirements and constraints. If the terms of a statute and a treaty conflict, the more recently adopted will prevail if both are constitutional.

The implementation of a tax treaty does not involve the same legislative process as the enactment of a revenue bill. The President has the power to make treaties, but the Senate must approve by a two-thirds vote. By contrast, all revenue bills must originate in the House of Representatives.

For many years, after the Senate had ratified a tax treaty, Congress then passed implementing legislation approving the treaty.[90] Some treaties affecting revenue provided explicitly that the treaty would not become effective until Congress enacted legislation approving its terms. In 1936, the year of the first U.S. income tax treaty, Congress enacted legislation providing, in effect, that statutory rules taxing income would thereafter yield to treaty rules preventing U.S. tax. That legislation, in slightly different form, remains in force today. In addition, in enacting the Internal Revenue Code of 1954, Congress provided that any provision of the Code that violates a U.S. treaty obligation in effect on the date of enactment (August 16, 1954) will not apply to situations covered by the treaty provision.

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[90] For authorities that indicate that there is a Constitutional requirement for legislation to give effect to ratified treaties affecting revenue, see *Constitution, Jefferson's Manual, and Rules of the House of Representatives*, H.R. Doc. No. 97-271, 97th Cong., 2d Sess., sec. 597 (1983), and authorities cited therein; S. Crandall, *Treaties: Their Making and Enforcement* 183-99 (2d ed. 1916), and authorities cited therein; *compare* the dictum in *Edwards* v. *Carter*, 580 F.2d 1055, 1058-59 (D.C. Cir. 1978) (per curiam) (treaties cannot increase taxes without implementing legislation); and the similar dictum in the dissenting opinion, 580 F.2d 1064, 1070-71, 1076; *with Armstrong* v. *United States*, —— F.2d —— (9th Cir., May 7, 1985), holding that "all legislation relating to taxes (and not just bills raising taxes) must be initiated in the House." *But see* Restatement (Second) of the Foreign Relations Law of the United States, sec. 141, comment 3 (1962); American Law Institute, Tentative Draft No. 6, Foreign Relations Law of the United States, sec. 131 (a working paper which has not been approved by the Members of the American Law Institute and does not represent the position of the Institute on any of the issues with which it deals); *Revenue Act, 1936: Hearings on H.R. 12395 Before Senate Comm. on Finance*, 74th Cong., 2d Sess. 43 (1936) (Chief of Staff of Joint Committee on Internal Revenue Taxation stated that the purpose of the 1936 legislation that first gave priority to treaties was to prevent overriding of the first income tax treaty); L. Henkin, Foreign Affairs and the Constitution 159 (1972) (concluding that the Constitution does not require legislation, but that Congress has insisted that legislation is necessary and the executive has generally acquiesced). There do not appear to be any decided cases involving such Constitutional challenges to a tax treaty. Since treaty provisions do not increase tax liabilities, taxpayers may never challenge the validity of treaties.

In recent years, Congress has overridden treaty obligations in a number of cases. The Revenue Act of 1962 expressly provided that its provisions would prevail over conflicting treaty provisions. The Treasury Department eventually identified only one treaty conflict, with the Greek estate tax treaty, which was promptly renegotiated to resolve the conflict. The General Explanation of the Tax Reform Act of 1976, which had eliminated use of the per country foreign tax credit limitation, states that the changes made by the Act were to prevail despite any treaty per country limitations. The conferees on the Crude Oil Windfall Profit Tax Act of 1980 stated in their report that they did not know of any treaty obligations that would conflict with that Act, but that they intended that the Act prevail if there were any conflicts. The Foreign Investment in Real Property Tax Act of 1980 expressly overrode treaties, but only after 1984. The Tax Reform Act of 1984 overrode treaties that might prevent imposition of its stapled stock provision, but with a grandfather provision for existing arrangements. The legislative history of the 1984 Act indicates that its definition of nonresident alien, by contrast, is not to override treaties.

Treaties do not increase U.S. tax liability for any taxpayer. U.S. income tax treaties generally provide that if the internal law of either country would result in lower tax liability for any taxpayer than would the treaty, the taxpayer may elect the more favorable non treaty rules.

In general, the treaties require the United States to reduce its tax on foreign taxpayers, rather than on U.S. taxpayers. The United States agrees to reduce taxes on U.S. income that residents of the other country earn because the United States assumes that the other country will tax that income. In return, the other country reduces its tax when U.S. taxpayers earn similar income arising in that country. The United States can then tax that foreign income. As an exception to the general rule, most treaties require the United States to allow U.S. taxpayers a foreign tax credit for taxes the other country collects on local income.

In some instances, investors from a country that does not have a treaty with the United States establish a conduit entity in a country that does. The investors then cause that conduit to earn income from the United States and claim treaty protection for that income ("treaty shopping"). Recent U.S. treaties (and recent revenue rulings interpreting older treaties) have denied benefits to conduits owned by investors who are not residents of the treaty partner country, unless they are using a treaty country entity for legitimate business operations rather than to avoid tax. The recent treaties use a two-pronged method of denying benefits to treaty shoppers. First, they deny benefits if the entity in the treaty country belongs to third-country residents. Second, they deny benefits if the entity makes substantial deductible payments (like interest or royalties) to third-country residents. The treaties allow benefits to legitimate businesses.

Administration Proposal

The Administration has tailored two of its proposals to avoid possible treaty violations. These proposals are the dividends paid deduction and the branch profits tax.

The Administration proposal would allow a 10-percent dividends paid deduction to U.S. corporations. The purpose of this deduction is to reduce the burden of the two-tiered taxation of corporate profits under the "classical" system of present law, which imposes a tax at the corporate and shareholder levels. The dividends paid deduction would extend to dividends paid to foreign shareholders. Absent treaty protection, however, such dividends would bear a compensatory withholding tax designed to prevent elimination of all tax on 10 percent of corporate profits where shareholders are not U.S. taxpayers.

Most U.S. treaties limit the U.S. tax paid on dividends. The Administration proposal would not initially impose a compensatory tax on dividends paid to treaty country entities. It would, however, delegate to the Secretary of the Treasury the authority to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis. The purpose of this delegation is to address two problems.

First, many countries which reduce the burden of the two-tier tax do so through a mechanism other than a dividends paid deduction. These countries give resident shareholders a tax credit when they receive dividends. That credit reflects taxes that the corporation paid on the profits it is distributing in the form of dividends. For the shareholder, the credit is basically the economic equivalent of a dividends paid deduction.[91] However, these countries generally do not give this credit to foreign shareholders unilaterally. Some of these countries, however, have given part of this credit to U.S. shareholders by treaty. No U.S. income tax treaty currently in force achieves for U.S. shareholders of foreign corporations the same treatment as local shareholders, however. The Secretary could impose the compensatory withholding tax if the home country of the recipient continued to deny economically equivalent relief to dividends paid by local companies to American shareholders.

Second, the proposal, at least initially, would respect treaty shopping arrangements whereby a foreigner whose country has no treaty with the United States establishes a conduit entity in a third country that has a treaty with the United States and then claims the benefits of that treaty. That is, there would be no compensatory withholding tax on payments to treaty shopping conduit entities. Here, too, the proposal would delegate the authority to the Secretary of the Treasury to override treaties to impose a compensatory dividend withholding tax on a country-by-country basis.

The Administration limits its proposal for the adoption of a branch-level tax, discussed in Part VI above, so that it would not override treaties. The Treasury Department would seek to renegotiate treaties to allow the United States to impose that tax.

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[91] To be fully equivalent to a deduction, the credit must be refundable. Many countries make the credit refundable.

Other Possible Proposals

1. Reverse the presumption in the Code that a treaty effective prior to a statute prevails over the statute.
2. Require Congress to enact implementing legislation before treaties affecting revenue become effective.
3. Deny treaty benefits by statute to entities that serve as conduits for third country nationals.

Analysis

Administration proposal

In seeking to renegotiate rather than override treaties, the Administration proposal would give weight to U.S. treaty obligations and would respect the expectations of U.S. treaty partners. Some argue that treaties reflect understandings between nations, and that the United States should unilaterally violate its agreement with another country only in rare situations. They add that it is unfair for the United States to break bargains piece-by-piece, that is, to honor those parts of the bargain that it finds attractive, while the United States violates the parts less advantageous to itself, and at the same time to insist that the other country honor all its obligations.

Others note the increasing complexity and rapid change in the Code in recent years, and argue that these factors often cause a need for changes in treaty provisions. They contend that treaties have become so detailed and far-reaching that they govern internal policy matters that the United States has a right to change when it wishes. They argue that violation of tax treaties by statute for domestic tax policy reasons is different in kind, not just in degree, from violation, for example, of strategic alliances. They note that even very recently negotiated treaties for which the Administration is presently seeking Senate consent do not reflect the policy changes that the Administration's tax reform plan proposes with respect to the branch level tax and relief from two-tiered corporate taxation. They point to instances where treaty obligations and Code provisions combine to produce unintended results. For instance, prior to Congressional action in 1984, U.S. taxpayers had Swiss subsidiaries hold stock in Domestic International Sales Corporations (DISCs). The Internal Revenue Service eventually held that a Swiss subsidiary, under the technical language of the Swiss treaty, was exempt from U.S. tax on a distribution from the DISC: although that income was effectively connected under the Code, the Swiss treaty prevented the United States from taxing it unless it was U.S. source effectively connected income. In 1984, Congress changed the Code prospectively to make that income U.S. source income so that the United States could tax it.

The Administration proposal for dividend relief illustrates the complexity of the interrelationship between the Code and treaties. In proposing a dividends paid deduction, the Administration rejected a shareholder credit device that could accomplish exactly the same economic result.[92] Those U.S. treaty partners that relieve

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[92] Analysis of the Administration's choice of devices will appear in a forthcoming staff pamphlet.

double corporate tax use that rejected credit device and do not always allow refunds of the credit to foreign shareholders. The rejected credit device could have denied benefits to residents of treaty partners without overriding treaties, while the Administration proposal, absent a unilateral exception from the compensatory withholding tax, would have overridden treaties. On the one hand, even a technical treaty violation creates concern. On the other hand, this technical treaty violation—the compensatory withholding tax—would accomplish the same result that other countries have accomplished without technically violating treaties. Thus, the Administration proposal arguably honors the form of treaty obligations and disregards the substance.

Treaties, however, provide significant benefits to the United States and to U.S. taxpayers. Treaties reduce foreign taxes that U.S. taxpayers pay. These reductions sometimes benefit the taxpayer; sometimes they benefit the U.S. Treasury, because they reduce foreign tax credits and thus increase U.S. tax. Treaty reductions of U.S. tax on foreign persons tend to increase the inflow of foreign capital to the United States. Unilaterally overriding treaties, even in a technical way, might give other countries an excuse to violate their obligations to the United States and to U.S. taxpayers. General or selective retaliation could harm U.S. interests. The tax reductions that foreign countries grant by treaty may exceed the tax reductions that the United States grants, so the United States may be better off, just considering tax amounts, with the whole system of current treaties than without it.

The Administration proposal to grant authority to the executive branch to impose compensatory withholding taxes overriding treaties attempts to address the concern about unilateral extension of the dividends paid deduction to foreign persons whose countries discriminate against U.S. investors. As an alternative to this proposal, Congress could instead impose the compensatory tax from the outset (its effective date), but could list the countries that grant adequate relief to U.S. investors so that the compensatory withholding tax would not apply to their investors.

(A discussion of the treaty issues raised by the Administration's branch-level tax proposal appears above, in Part VI. D.)

Statutory concession of priority to treaties

In recent years, with provisions in treaties and the Code conflicting more frequently, Congress has rarely been willing for treaties to prevent legislation from taking full effect and so has explicitly overridden treaties more frequently. Reversal of the statutory presumption that treaties prevail over the Code, to provide that the Code prevails over treaties, might therefore reflect the outcome that Congress more likely intends. When Congress decides not to override treaties, Congress could say so explicitly. Reversal of the statutory presumption, however, could cause Congress to override treaties without intending to do so. Despite the canon of construction that intent to override a treaty will not be lightly inferred, reversal of the presumption could lead to inadvertent treaty violations if the Code and the treaty cannot be reconciled.

Implementing legislation

Congress has the primary responsibility for the U.S. tax system. A requirement of implementing legislation would allow full consideration of the issues that treaties present. Implementing legislation would allow examination of tax treaties by the House and by the House Committee on Ways and Means and the Senate Committee on Finance. It might reduce the necessity for overriding treaties. The combination of the Constitutional requirement that tax bills originate in the House and the current practice of treaty approval by ongoing statutory concession without current House involvement puts the House in the position of always participating in any tax increase without currently participating in the tax reductions that treaties provide. The tax writing committees currently are in the same position. In addition, implementing legislation would allow treaties to increase tax in cases, if any, where increases are appropriate.

Many other countries require implementing legislation before treaties become effective. A requirement of implementing legislation would not violate any international norm.

On the other hand, requiring implementing legislation could slow down legislative approval process for treaties and delay the benefits that treaties provide. Requiring implementing legislation might result in Congressional action that changes the terms of an international agreement. That kind of action might disappoint the expectations of the treaty partner country.

Treaty shopping

Advocates of anti-treaty shopping legislation see little justification for treaty use by persons other than the residents of the U.S. treaty partner unless those persons are engaged in a legitimate business in the treaty partner country. They contend that the treaty program should require mutual concessions, but that a country will have little incentive to make a treaty granting concessions to the United States if its investors can use some third country's treaty to obtain U.S. tax benefits. They argue that treaty shopping creates a "one way treaty with the world": a situation where the United States gets the disadvantages of treaties with few of the advantages.

Defenders of treaty shopping argue that the United States foresaw and even encouraged treaty shopping to increase foreign portfolio investment in the United States at the time some treaties became effective. They argue that the United States should not reverse that policy now. They contend that countries where treaty shopping is possible may have made concessions to the United States to obtain the benefits of having foreign investors establish conduits there. They argue that it is unfair for the United States to renege on its part of the bargain unilaterally. In addition, the United States seeks the friendship and economic stability of some of these countries. In some countries that provide treaty shopping opportunities, the offshore financial sector of the economy is so a large part of the total economy that termination of treaty shopping would cause the country to suffer economically.

Opponents of treaty shopping contend that, even if the United States once condoned treaty shopping, it should be free to change policies as times change and as U.S. law evolves. They argue that the United States has found better ways to encourage foreign investment than the treaty shopping device.

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